INCOME

TAX

REGULATIONS

Under the Internal Revenue Code of 1954

Issued June–December, 1956

Part 1 of Title 26 (1954)

Code of Federal Regulations

United States Treasury Department

Internal Revenue Service

Publication No. 329–2

For sale by the Superintendent of Documents, U. S. Government Printing Office
Washington 25, D. C. - Price $1.75

NOTE

The regulatory provisions appearing in this pamphlet are a compilation of all portions of the Income Tax Regulations issued under the Internal Revenue Code of 1954 during the period June 1, 1956 through December 31, 1956. These provisions were published in daily issues of the Federal Register in compliance with the Administrative Procedure Act (5 USC 1001) and were later reprinted in the weekly issues of the Internal Revenue Bulletin. A limited number of these pamphlets have been prepared for use until complete Income Tax Regulations under Part 1, Title 26 (1954), Code of Federal Regulations are available in book form. A previously issued pamphlet in this series, Publication No. 329–1, contained the Income Tax Regulations issued under the 1954 Code since August 16, 1954, and prior to June 1, 1956. It is expected that additional pamphlets in this series will be issued from time to time when the volume of additional published income tax regulations justifies such action.

EXPLANATION OF APPLICABILITY AND ARRANGEMENT OF INCOME TAX REGULATIONS

SCOPE—The regulations relating to the income taxes imposed by the Internal Revenue Code of 1954 have been designated Income Tax Regulations (26 CFR Part 1). These regulations relate to subtitle A (chs. 1–6, incl.) and certain related administrative provisions of subtitle F of the 1954 Code. The practice of assigning a separate Internal Revenue Service number to new regulations (such as Regulations 111 or Regulations 118) has been discontinued.

APPLICABILITY—Income Tax Regulations (26 CFR Part 1) generally are applicable to taxable years beginning after December 31, 1953, and ending after August 16, 1954. However, in those instances where the applicability of the provision of law is stated in terms of a specific date occurring after December 31, 1953, or in terms of taxable years ending after a specific date occurring after December 31, 1953, these regulations may also relate to the income taxes imposed by the Internal Revenue Code of 1939. Two other principal exceptions to this rule are the regulations under chapters 3 and 5 of the 1954 Code, which are applicable to payments and transfers occurring after December 31, 1954.

ARRANGEMENT AND NUMBERING—The Income Tax Regulations are subject to codification in the Code of Federal Regulations and are published as Part 1, Subchapter A, Chapter I, Title 26 (1954) of that Code. As a document subject to codification, the arrangement and numbering conforms to the rules prescribed by the Administrative Committee of the Federal Register in Part 1, Chapter I, Title 1 of the Code of Federal Regulations.

Except for the regulations relating to estates and trusts under subchapter J, chapter 1 of the Internal Revenue Code of 1954, each section of the regulations is preceded by the section, subsection or paragraph of that Code which it interprets. Certain sections of the regulations relating to estates and trusts contain material of an introductory nature and are not preceded by any of the provisions of the law to which they relate. The sections of the regulations can readily be distinguished from sections of the Code since—

1. The sections of the regulations are printed in larger type;
2. The sections of the regulations are preceded by a section symbol and the part number, arabic numeral 1, followed by a decimal point (§ 1.) and;
3. The sections of the Code are preceded by "Sec.".

Each section of the regulations setting forth law or regulations is designated by a number composed of the part number followed by a decimal point (1.) and the number of the corresponding provision of the Internal Revenue Code of 1954. In the case of a section setting forth regulations, this designation is followed by a dash (—) and

a number identifying such a section. By use of these designations one can ascertain the sections of the regulations relating to a provision of the Code. Thus, the section of the regulations setting forth section 301 of the 1954 Code is designated § 1.301, and the regulations pertaining to such section 301 is designated § 1.301–1.

In some cases the regulations are broken down in such manner as to relate to a single subsection of a section rather than to the section as a whole. Thus, the regulations under section 108 are broken down so that those under section 108(a) are designated as § 1.108(a)–1 and § 1.108(a)–2 and those under section 108(b) are designated as § 1.108(b)–1. Generally, however, the regulations will not be broken down in such manner as to indicate, by specific designation, that they relate to any division of law inferior to a subsection. Thus, for example, the section of the regulations which contains regulations under section 108(a)(2) of the Internal Revenue Code of 1954 is designated § 1.108(a)–2 rather than § 1.108(a)(2)–1.

In some cases several sections of the regulations relate to a single section or subsection of the Internal Revenue Code of 1954. For example, §§ 1.105–1 to 1.105–5, inclusive, all deal with section 105 of the Code. Similarly, both § 1.108(a)–1 and § 1.108(a)–2 deal with section 108(a) of the Code.

Regulations under certain revenue laws not included in the Internal Revenue Code of 1954 depart from the numbering described in the preceding paragraphs. See, for example, the regulations issued under Public Law 74, Eighty-fourth Congress (§§ 1.9000–1 to 1.9000–8, incl.).

As an additional convenience to the reader, a partial comparison of the system of numbering the various divisions of the Code of Federal Regulations and the Internal Revenue Code of 1954 is set forth below:

	Code of Federal Regulations		*Internal Revenue Code of 1954*	
Division	*Description of Number*	*Example*	*Description of Number*	*Example*
Section	Arabic numeral separated from the part number by a decimal: Section setting forth law	1. 31	Arabic numeral	31
	Section setting forth regulations	1. 31–1		
Subsection	(None)	------	Small letter in parentheses	(a)
*Paragraph	Small letter in parentheses	(a)	Arabic numeral in parentheses	(1)
Subparagraph	Arabic numeral in parentheses	(1)	Capital letter in parentheses	(A)
Subdivision	Small roman numeral in parentheses	(i)	Small roman numeral in parentheses	(i)
Inferior subdivisions	Small italic letter in parentheses	(*a*)	None	

[*It should be noted that the first internal division of a regulations section is "paragraph" and the first internal division of a law section is "subsection."]

MEANING OF TERMS—References to a section or other provision of law are references to a section or other provision of the Internal Revenue Code of 1954 unless otherwise indicated.

The term "the regulations in this part" when used in these regulations means the regulations in Part 1, Subchapter A, Chapter I, Title 26 (1954), of the Code of Federal Regulations, that is, the Income Tax Regulations (26 CFR Part 1).

TABLE OF CONTENTS—There is shown preceding the text of the regulations a table of the sections containing statutory or regulatory provisions which appear in this publication.

INDEX—An index to the material contained in this publication follows the text of the regulatory material.

TABLE OF CONTENTS

TEMPORARY RULES

INCOME TAX REGULATIONS

INCOME TAXES

NORMAL TAXES AND SURTAXES

COMPUTATION OF TAXABLE INCOME

ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

Treatment of Excess Distributions by Trusts

416926°—57——2

Partners and Partnerships

DEFINITIONS

Insurance Companies

LIFE INSURANCE COMPANIES

MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES)

OTHER INSURANCE COMPANIES

PROVISIONS OF GENERAL APPLICATION

Gain or Loss on Disposition of Property

BASIS RULES OF GENERAL APPLICATION

COMMON NONTAXABLE EXCHANGES

SPECIAL RULES

CHANGES TO EFFECTUATE F. C. C. POLICY

EXCHANGES IN OBEDIENCE TO S. E. C. ORDERS

WASH SALES OF STOCK OR SECURITIES

Capital Gains and Losses

SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

TAX ON SELF-EMPLOYMENT INCOME

WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS AND TAX-FREE COVENANT BONDS

Nonresident Aliens and Foreign Corporations

Tax-Free Covenant Bonds

Application of Withholding Provisions

RULES APPLICABLE TO RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

Recovery of Excessive Profits on Government Contracts

Mitigation of Effect of Renegotiation of Government Contracts

RELATED ADMINISTRATIVE PROVISIONS

[SOURCE:

TEMPORARY RULES

Par. 25, T.D. 6208, 21 F.R. 8082, October 20, 1956; C.B. 1956–2, 1369.

Par. 26, T.D. 6209, 21 F.R. 8319, October 31, 1956; C.B. 1956–2, 1370.

INCOME TAX REGULATIONS

§§ 1.72 through 1.72–14, T.D. 6211, 21 F.R. 8853, November 15, 1956; C.B. 1956–2, 29.

§§ 1.102 through 1.103–6, T.D. 6220, 21 F.R. 10484, December 29, 1956; I.R.B. 1957–2, 7.

§§ 1.109 through 1.115–1, T.D. 6220, 21 F.R. 10484, December 29, 1956; I.R.B. 1957–2, 7.

§§ 1.117 through 1.117–4, T.D. 6186, 21 F.R. 4869, June 30, 1956; C.B. 1956–2, 104.

§§ 1.118 through 1.121, T.D. 6220, 21 F.R. 10484, December 29, 1956; I.R.B. 1957–2, 7.

§§ 1.167(a) through 1.167(h)–1, T.D. 6182, 21 F.R. 3985, June 12, 1956; C.B. 1956–1, 98.

§§ 1.172 through 1.172–8, T.D. 6192, 21 F.R. 5525, July 24, 1956; C.B. 1956–2, 132.

§§ 1.214 through 1.214–1, T.D. 6184, 21 F.R. 4403, June 22, 1956; C.B. 1956–2, 157.

§§ 1.241 through 1.248–1, T.D. 6183, 21 F.R. 4075, June 14, 1956; C.B. 1956–1, 136.

§§ 1.401 through 1.404(d)–1, T.D. 6203, 21 F.R. 7269, September 25, 1956; C.B. 1956–2, 219.

§§ 1.581 through 1.601–1, T.D. 6188, 21 F.R. 5000, July 6, 1956; C.B. 1956–2, 310.

§§ 1.641–1 through 1.678(d)–1, T.D. 6217, 21 F.R. 10207, December 20, 1956; C.B. 1956–2, 336.

§§ 1.683 through 1.683–3, T.D. 6217, 21 F.R. 10207, December 20, 1956; C.B. 1956–2, 336.

§§ 1.761–1(a)(2) (amendments), T.D. 6198, 21 F.R. 6130, August 16, 1956; C. B. 1956–2, 461.

§§ 1.801 through 1.801–1, T.D. 6201, 21 F.R. 6640, September 5, 1956; C.B. 1956–2, 468.

§§ 1.802(b) through 1.802(b)–1, T.D. 6201, 21 F.R. 6640, September 5, 1956; C. B. 1956–2, 468.

§§ 1.803 through 1.803–6, T.D. 6201, 21 F.R. 6640, September 5, 1956; C.B. 1956–2, 468.

§§ 1.805 through 1.807–1, T.D. 6201, 21 F.R. 6640, September 5, 1956; C.B. 1956–2, 468.

§§ 1.821 through 1.842, T.D. 6201, 21 F.R. 6640, September 5, 1956; C.B. 1956–2, 468.

§§ 1.1021 through 1.1021–1, T.D. 6211, 21 F.R. 8853, November 15, 1956; C.B. 1956–2, 29.

§§ 1.1031(a) through 1.1032–1, T.D. 6210, 21 F.R. 8536, November 7, 1956; C.B. 1956–2, 508.

§§ 1.1034 through 1.1034–1, T.D. 6179, 21 F.R. 3778, June 2, 1956; C.B. 1956–1, 326.

§§ 1.1035 through 1.1035–1, T.D. 6211, 21 F.R. 8853, November 15, 1956; C.B. 1956–2, 29.

§§ 1.1036 through 1.1036–1, T.D. 6210, 21 F.R. 8536, November 7, 1956; C.B. 1956–2, 508.

§§ 1.1051 through 1.1091–2, T.D. 6178, 21 F.R. 3782, June 2, 1956; C.B. 1956–1, 340.

[SOURCE—Continued

§§ 1.1233 through 1.1233–1, T.D. 6207, 21 F.R. 7981, October 18, 1956; C.B. 1956–2, 529.

§§ 1.1401 through 1.1403–1, T.D. 6196, 21 F.R. 6059, August 14, 1956; C.B. 1956–2, 537.

§§ 1.1441 through 1.1465–1, T.D. 6187, 21 F.R. 5006, July 6, 1956; C.B. 1956–2, 567.

§§ 1.1461–1 through 1.1461–3 (amendments), T.D. 6213, 21 F.R. 9055, November 21, 1956; C.B. 1956–2, 590.

§§ 1.1471 through 1.1481, T.D. 6187, 21 F.R. 5006, July 6, 1956; C.B. 1956–2, 567.

§§ 1.6033(a) and 1.6033–1(a)(3), T.D. 6203, 21 F.R. 7269, September 25, 1956; C.B. 1956–2, 219.]

TEMPORARY RULES RELATING TO THE INCOME TAX AND ADMINISTRATIVE MATTERS UNDER THE INTERNAL REVENUE CODE OF 1954

The following rules, prescribed under the Internal Revenue Code of 1954 (Public Law 591, 83d Cong., approved Aug. 16, 1954), relate to certain elections or other actions by taxpayers under provisions of such Code which do not correspond to provisions of the Internal Revenue Code of 1939 (as to cases involving corresponding provisions, see sec. 7807 of the Internal Revenue Code of 1954 and T.D. 6091, approved Aug. 16, 1954).

The rules set forth herein are designed to inform taxpayers as to how, when, and where to perform certain acts required or permitted under the Internal Revenue Code of 1954. More comprehensive rules with respect to the subjects involved will be incorporated in subsequent regulations under the Code. The inclusion in this Treasury Decision of rules relating to certain acts is intended to assist taxpayers in the performance of such acts. Rules with respect to other acts required or permitted by other provisions of the 1954 Code will be covered in subsequent regulations.

[For rules set forth in Paragraphs 1 to 24, inclusive, see previously issued pamphlet in this series (Publication No. 329-1).]

PARAGRAPH 1. ANNUITIES; CERTAIN PROCEEDS OF ENDOWMENT AND LIFE INSURANCE CONTRACTS; ACTUARIAL TABLES.

[Superseded by permanent regulations—T.D. 6211, 21 F.R. 8853, November 15, 1956; C. B. 1956–2, 29.]

PAR. 3. AGREEMENTS AS TO USEFUL LIFE AND RATE OF DEPRECIATION.

[Superseded by permanent regulations—T.D. 6182, 21 F.R. 3985, June 12, 1956; C.B. 1956–1, 98.]

PAR. 7. ORGANIZATIONAL EXPENDITURES; TIME AND MANNER OF MAKING ELECTION.

[Superseded by permanent regulations—T.D. 6183, 21 F.R. 4075, June 14, 1956; C.B. 1956–1, 136.]

PAR. 25. USE OR RESALE OF UNUSED DOCUMENTARY STAMPS.—Unused documentary stamps may be used at any time in payment of any tax imposed by chapter 34 of the Internal Revenue Code of 1954 (or corresponding provisions of the Internal Revenue Code of 1939), or may be resold by the owner at any time. For redemption of unused documentary stamps, see section 6805 of the Internal Revenue Code of 1954.

[This paragraph is not applicable to Income Taxes.]

PAR. 26. TRADEMARK AND TRADE NAME EXPENDITURES; ELECTION TO TREAT SUCH EXPENDITURES AS DEFFERRED EXPENSES; MANNER OF MAKING ELECTION.—Section 177 provides that a taxpayer may elect to treat any trademark or trade name expenditure, as defined in section 177(b), paid or incurred during a taxable year beginning after December 31,

1955, as deferred expense. Any expenditure so treated shall be allowed as a deduction ratably over a period (selected by the taxpayer) of not less than 60 months (beginning with the first month of the taxable year in which the expenditure is paid or incurred). A taxpayer who elects to so treat any trademark or trade name expenditure paid or incurred during a taxable year shall, within the time prescribed by law for filing his return (including extensions thereof) for that year, signify his election by attaching to the return a statement identifying the character and amount of the expenditures to which the election applies. The statement shall also specify the number of months (not less than 60) during which the expenditures are to be ratably deducted. An election, insofar as it applies to a particular expenditure, is irrevocable, but separate elections may be made with respect to other trademark or trade name expenditures.

INCOME TAX REGULATIONS

Income Taxes

NORMAL TAXES AND SURTAXES

Computation of Taxable Income

ITEMS SPECIFICALLY INCLUDED IN GROSS INCOME

§ 1.72 Statutory Provisions; Annuities; Certain Proceeds of Endowment and Life Insurance Contracts.

SEC. 72. ANNUITIES; CERTAIN PROCEEDS OF ENDOWMENT AND LIFE INSURANCE CONTRACTS.

(a) General Rule for Annuities.—Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

(b) Exclusion Ratio.—Gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). This subsection shall not apply to any amount to which subsection (d)(1) (relating to certain employee annuities) applies.

(c) Definitions.—

(1) Investment in the contract.—For purposes of subsection (b), the investment in the contract as of the annuity starting date is—

(A) the aggregate amount of premiums or other consideration paid for the contract, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

(2) Adjustment in investment where there is refund feature.—If—

(A) the expected return under the contract depends in whole or in part on the life expectancy of one or more individuals;

(B) the contract provides for payments to be made to a beneficiary (or to the estate of an annuitant) on or after the death of the annuitant or annuitants; and

(C) such payments are in the nature of a refund of the consideration paid,

then the value (computed without discount for interest) of such payments on the annuity starting date shall be subtracted from the amount determined under paragraph (1). Such value shall be computed in accordance with actuarial tables prescribed by the Secretary or his delegate. For purposes of this paragraph and of subsection (e)(2)(A), the term "refund of the consideration paid" includes amounts payable after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain, but (if part of the consideration was contributed by an employer) does not include that part of any payment to a beneficiary (or to the estate of the annuitant) which is not attributable to the consideration paid by the employee for the contract as determined under paragraph (1)(A).

(3) Expected return.—For purposes of subsection (b), the expected return under the contract shall be determined as follows:

(A) Life expectancy.—If the expected return under the contract, for the period on and after the annuity starting date, depends in

whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary or his delegate.

(B) INSTALLMENT PAYMENTS.—If subparagraph (A) does not apply, the expected return is the aggregate of the amounts receivable under the contract as an annuity.

(4) ANNUITY STARTING DATE.—For purposes of this section, the annuity starting date in the case of any contract is the first day of the first period for which an amount is received as an annuity under the contract: except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954.

(d) EMPLOYEES' ANNUITIES.—

(1) EMPLOYEE'S CONTRIBUTIONS RECOVERABLE IN 3 YEARS.—Where—

(A) part of the consideration for an annuity, endowment, or life insurance contract is contributed by the employer, and

(B) during the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received under the contract as an annuity, the aggregate amount receivable by the employee under the terms of the contract is equal to or greater than the consideration for the contract contributed by the employee,

then all amounts received as an annuity under the contract shall be excluded from gross income until there has been so excluded (under this paragraph and prior income tax laws) an amount equal to the consideration for the contract contributed by the employee. Thereafter all amounts so received under the contract shall be included in gross income.

(2) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (1).—For purposes of paragraph (1), if the employee died before any amount was received as an annuity under the contract, the words "receivable by the employee" shall be read as "receivable by a beneficiary of the employee".

(3) CROSS REFERENCE.—For certain rules for determining whether amounts contributed by employer are includible in the gross income of the employee, see part I of subchapter D (sec. 401 and following, relating to pension, profit-sharing, and stock bonus plans, etc.).

(e) AMOUNTS NOT RECEIVED AS ANNUITIES.—

(1) GENERAL RULE.—If any amount is received under an annuity, endowment, or life insurance contract, if such amount is not received as an annuity, and if no other provision of this subtitle applies, then such amount—

(A) if received on or after the annuity starting date, shall be included in gross income; or

(B) if subparagraph (A) does not apply, shall be included in gross income, but only to the extent that it (when added to amounts previously received under the contract which were excludable from gross income under this subtitle or prior income tax laws) exceeds the aggregate premiums or other consideration paid.

For purposes of this section, any amount received which is in the nature of a dividend or similar distribution shall be treated as an amount not received as an annuity.

(2) SPECIAL RULES FOR APPLICATION OF PARAGRAPH (1).—For purposes of paragraph (1), the following shall be treated as amounts not received as an annuity:

(A) any amount received, whether in a single sum or otherwise, under a contract in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract; and

(B) any amount received under a contract on its surrender, redemption, or maturity.

In the case of any amount to which the preceding sentence applies, the rule of paragraph (1)(B) shall apply (and the rule of paragraph (1)(A) shall not apply).

(3) LIMIT ON TAX ATTRIBUTABLE TO RECEIPT OF LUMP SUM.—If a lump sum is received under an annuity, endowment, or life insurance contract, and the part which is includible in gross income is determined under paragraph (1), then the tax attributable to the inclusion of such part in gross income for the taxable year shall not be greater than the

aggregate of the taxes attributable to such part had it been included in the gross income of the taxpayer ratably over the taxable year in which received and the preceding 2 taxable years.

(f) SPECIAL RULES FOR COMPUTING EMPLOYEES' CONTRIBUTIONS.—In computing, for purposes of subsection (c)(1)(A), the aggregate amount of premiums or other consideration paid for the contract, for purposes of subsection (d)(1), the consideration for the contract contributed by the employee, and for purposes of subsection (e)(1)(B), the aggregate premiums or other consideration paid, amounts contributed by the employer shall be included, but only to the extent that—

(1) such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws; or

(2) if such amounts had been paid directly to the employee at the time they were contributed, they would not have been includible in the gross income of the employee under the law applicable at the time of such contribution.

(g) RULES FOR TRANSFEREE WHERE TRANSFER WAS FOR VALUE.—Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

(h) OPTION TO RECEIVE ANNUITY IN LIEU OF LUMP SUM.—If—

(1) a contract provides for payment of a lump sum in full discharge of an obligation under the contract, subject to an option to receive an annuity in lieu of such lump sum;

(2) the option is exercised within 60 days after the day on which such lump sum first became payable; and

(3) part or all of such lump sum would (but for this subsection) be includible in gross income by reason of subsection (e)(1),

then, for purposes of this subtitle, no part of such lump sum shall be considered as includible in gross income at the time such lump sum first became payable.

(i) JOINT AND SURVIVOR ANNUITIES WHERE FIRST ANNUITANT DIED IN 1951, 1952, OR 1953.—Where an annuitant died after December 31, 1950, and before January 1, 1954, and the basis of a surviving annuitant's interest in the joint and survivor annuity contract was determinable under section 113(a)(5) of the Internal Revenue Code of 1939, then—

(1) subsection (d) shall not apply with respect to such contract;

(2) for purposes of this section, the aggregate amount of premiums or other consideration paid for the contract is the basis of the contract determined under such section 113(a)(5);

(3) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received by the surviving annuitant under the contract before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(4) the annuity starting date is January 1, 1954, or the first day of the first period for which the surviving annuitant received an amount under the contract as an annuity, whichever is the later.

(j) INTEREST.—Notwithstanding any other provision of this section, if any amount is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.

(k) PAYMENTS IN DISCHARGE OF ALIMONY.—

(1) IN GENERAL.—This section shall not apply to so much of any payment under an annuity, endowment, or life insurance contract (or any interest therein) as is includible in the gross income of the wife under section 71 or section 682 (relating to income of an estate or trust in case of divorce, etc.).

(2) CROSS REFERENCE.—For definition of "wife", see section 7701(a) (17).

(l) FACE-AMOUNT CERTIFICATES.—For purposes of this section, the term "endowment contract" includes a face-amount certificate, as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U. S. C., sec. 80a–2), issued after December 31, 1954.

(m) CROSS REFERENCE.—For limitation on adjustments to basis of annuity contracts sold, see section 1021.

§ 1.72–1 INTRODUCTION.—(a) *General principle.*—Section 72 prescribes rules relating to the inclusion in gross income of amounts received under a life insurance, endowment, or annuity contract unless such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Internal Revenue Code. In general, these rules provide that amounts subject to the provisions of section 72 are includible in the gross income of the recipient except to the extent that they are considered to represent a reduction or return of premiums or other consideration paid.

(b) *Amounts to be considered as a return of premiums.*—For the purpose of determining the extent to which amounts received represent a reduction or return of premiums or other consideration paid, the provisions of section 72 distinguished between "amounts received as an annuity" and "amounts not received as an annuity." In general, "amounts received as an annuity" are amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date. See paragraphs (b)(2) and (3) of § 1.72–2. Any other amounts to which the provisions of section 72 apply are considered to be "amounts not received as an annuity." See § 1.72–11.

(c) "*Amounts received as an annuity.*"—(1) In the case of "amounts received as an annuity" (other than certain employees' annuities described in section 72(d) and in § 1.72–13), a proportionate part of each amount so received is considered to represent a return of premiums or other consideration paid. The proportionate part of each annuity payment which is thus excludable from gross income is determined by the ratio which the investment in the contract as of the date on which the annuity is deemed to begin bears to the expected return under the contract as of that date. See § 1.72–4.

(2) In the case of employees' annuities of the type described in section 72(d), no amount received as an annuity in a taxable year to which the Internal Revenue Code of 1954 applies is includible in the gross income of a recipient until the aggregate of all amounts received thereunder and excluded from gross income under the applicable income law exceeds the consideration contributed (or deemed contributed) by the employee under § 1.72–8. Thereafter, all amounts

so received are includible in the gross income of the recipient. See § 1.72–13.

(d) *"Amounts not received as an annuity."*—In the case of "amounts not received as an annuity," if such amounts are received after an annuity has begun and during its continuance, amounts so received are generally includible in the gross income of the recipient. Amounts not received as an annuity which are received at any other time are includible in the gross income of the recipient only to the extent that such amounts, when added to all amounts previously received under the contract which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt, exceed the premiums or other consideration paid. See § 1.72–11.

(e) *Classification of recipients.*—For the purpose of the regulations under section 72, a recipient shall be considered an "annuitant" if he receives amounts under an annuity contract during the period that the annuity payments are to continue, whether for a term certain or during the continuing life or lives of the person or persons whose lives measure the duration of such annuity. However, a recipient shall be considered a "beneficiary" rather than an "annuitant" if the amounts he receives under a contract are received after the term of the annuity for a life or lives has expired and such amounts are paid by reason of the fact that the contract guarantees that payments of some minimum amount or for some minimum period shall be made. For special rules with respect to beneficiaries, see paragraph (a) (1) (iii) and (c) of § 1.72–11.

§ 1.72–2 APPLICABILITY OF SECTION—(a) *Contracts.*—(1) The contracts under which amounts paid will be subject to the provisions of section 72 include contracts which are considered to be life insurance, endowment, and annuity contracts in accordance with the customary practice of life insurance companies. For the purposes of section 72, however, it is immaterial whether such contracts are entered into with an insurance company. The term "endowment contract" also includes the "face-amount certificates" described in section 72(l). In addition, sections 402 and 403 of the Code provide that certain employees' trust and plan distributions are subject to the provisions of section 72, except section 72(e) (3). In such cases the regulations under section 72 shall be applied to all the distributions with respect to a particular employee under each such trust or plan as though such payments were provided under a single contract to which section 72 applied. As used hereafter in these regulations, therefore, the term "contract" shall be considered to include the entire interest of an employee in each trust or plan described in sections 402 and 403 to the extent that distributions thereunder are subject to the provisions of section 72.

(2) If two or more annuity obligations or elements to which section 72 applies are acquired for a single consideration, such as an obligation to pay an annuity to A for his life accompanied by an obligation to pay an annuity to B for his life, there being a single consideration paid for both obligations (whether paid by one or more persons in equal or different amounts, and whether paid in a single sum or otherwise), such annuity elements shall be considered to comprise a single

contract for the purpose of the application of section 72 and the regulations thereunder. For rules relating to the allocation of investment in the contract in the case of annuity elements payable to two or more persons, see paragraph (b) of § 1.72–6.

(b) *Amounts.*—(1) (i) In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a) (1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Internal Revenue Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a) of the Code. See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a) (4), relating to compensation for injuries or sickness.

(ii) Section 72 does not exclude from gross income any amounts received under an agreement to hold an amount and pay interest thereon. See paragraph (a) of § 1.72–14. However, section 72 does apply to amounts received by a surviving annuitant under a joint and survivor annuity contract since such amounts are not considered to be paid by reason of the death of an insured. For a special deduction for the estate tax attributable to the inclusion of the value of the interest of a surviving annuitant under a joint and survivor annuity contract in the estate of the deceased primary annuitant, see section 691(d) and the regulations thereunder.

(2) Amounts subject to section 72 in accordance with subparagraph (1) are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) They must be received on or after the "annuity starting date" as that term is defined in paragraph (b) of §1.72–4;

(ii) They must be payable in periodic installments at regular intervals (whether annually, semiannually, quarterly, monthly, weekly, or otherwise) over a period of more than one full year from the annuity starting date; and

(iii) Except as indicated in subparagraph (3) of this paragraph, the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

For the purpose of determining whether amounts subject to section 72(d) and § 1.72–13 are "amounts received as an annuity," however, the provisions of subdivision (i) shall be disregarded. In addition, the term "amounts received as an annuity" does not include amounts received to which the provisions of paragraph (b) or (c) of § 1.72–11 apply, relating to dividends and certain amounts received by a beneficiary in the nature of a refund. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, the requirements of subdivision (iii) are met with respect

to the payments determinable at the outset by means of computations involving the fixed interest rate, but any payments received after the expiration of the period determinable by such computations shall be taxable as dividends received after the annuity starting date in accordance with paragraph (b) (2) of § 1.72–11.

(3) (i) Notwithstanding the requirement of subdivision (iii) of subparagraph (2), if amounts are to be received for a definite or determinable time whether for a period certain or for a life or lives under a contract which provides—

(*a*) That the amount of the periodic payments may vary in accordance with investment experience (as in certain profit-sharing plans), cost of living indices, or similar fluctuating criteria, or

(*b*) For specified payments the value of which may vary for income tax purposes, such as in the case of any annuity payable in foreign currency,

each such payment received shall be considered as an amount received as an annuity only to the extent that it does not exceed the amount computed by dividing the investment in the contract, as adjusted for any refund feature, by the number of periodic payments anticipated during the time that the periodic payments are to be made. If payments are to be made more frequently than annually, the amount so computed shall be multiplied by the number of periodic payments to be made during the taxable year for the purpose of determining the total amount which may be considered received as an annuity during such year. To this extent, the payments received shall be considered to represent a return of premiums or other consideration paid and shall be excludable from gross income in the taxable year in which received. See paragraph (d) (2) and (3) of § 1.72–4. To the extent that the payments received under the contract during the taxable year exceed the total amount thus considered to be received as an annuity during such year, they shall be considered to be amounts not received as an annuity and shall be included in the gross income of the recipient. See section 72(e) and paragraph (b) (2) of § 1.72–11.

(ii) For purposes of subdivision (i), the number of periodic payments anticipated during the time payments are to be made shall be determined by multiplying the number of payments to be made each year (*a*) by the number of years payments are to be made, or (*b*) if payments are to be made for a life or lives, by the multiple found by the use of the appropriate tables contained in § 1.72–9, as adjusted in accordance with the table in paragraph (a) (2) of § 1.72–5.

(iii) For an example of the computation to be made in accordance with this subparagraph and a special election which may be made in a taxable year subsequent to a taxable year in which the total payments received under a contract described in this subparagraph are less than the total of the amounts excludable from gross income in such year under subdivision (i), see paragraph (d) (3) of § 1.72–4.

§ 1.72–3 Excludable Amounts Not Income.—In general, amounts received under contracts described in paragraph (a) (1) of § 1.72–2 are not to be included in the income of the recipient to the extent that such amounts are excludable from gross income as the result of the application of section 72 and the regulations thereunder.

§ 1.72–4 Exclusion Ratio.—(a) *General rule.*—(1) (i) To determine the proportionate part of the total amount received each year as an annuity which is excludable from the gross income of a recipient in the taxable year of receipt (other than amounts received under certain employee annuities described in section 72(d) and § 1.72–13), an exclusion ratio is to be determined for each contract. In general, this ratio is determined by dividing the investment in the contract as found under § 1.72–6 by the expected return under such contract as found under § 1.72–5. Where a single consideration is given for a particular contract which provides for two or more annuity elements, an exclusion ratio shall be determined for the contract as a whole by dividing the investment in such contract by the aggregate of the expected returns under all the annuity elements provided thereunder. However, where the provisions of paragraph (b)(3) of § 1.72–2 apply to payments received under such a contract, see paragraph (b)(3) of § 1.72–6.

(ii) The exclusion ratio for the particular contract is then applied to the total amount received as an annuity during the taxable year by each recipient. See, however, paragraph (e)(3) of § 1.72–5. Any excess of the total amount received as an annuity during the taxable year over the amount determined by the application of the exclusion ratio to such total amount shall be included in the gross income of the recipient for the taxable year of receipt.

(2) The principles of subparagraph (1) may be illustrated by the following example:

> *Example.* Taxpayer A purchased an annuity contract providing for payments of \$100 per month for a consideration of \$12,650. Assuming that the expected return under this contract is \$16,000, the exclusion ratio to be used by A is $\frac{\$12,650}{\$16,000}$, or 79.1 percent (79.06 rounded to the nearest tenth). If 12 such monthly payments are received by A during his taxable year, the total amount he may exclude from his gross income in such year is \$949.20 (\$1,200×79.1 percent). The balance of \$250.80 (\$1,200 less \$949.20) is the amount to be included in gross income. If A instead received only five such payments during the year, he should exclude \$395.50 (\$500×79.1 percent) of the total amounts received.

For an example of the computation of the exclusion ratio in cases where two annuity elements are acquired for a single consideration, see paragraph (b)(1) of § 1.72–6.

(3) The exclusion ratio shall be applied only to amounts received as an annuity within the meaning of that term under paragraph (b)(2) and (3) of § 1.72–2. Where the periodic payments increase in amount after the annuity starting date in a manner not provided by the terms of the contract at such date, the portion of such payments representing the increase is not an amount received as an annuity. For the treatment of amounts not received as an annuity, see section 72(e) and § 1.72–11. For special rules where paragraph (b)(3) of § 1.72–2 applies to amounts received, see paragraph (d)(3) of this section.

(4) After an exclusion ratio has been determined for a particular

contract, it shall be applied to any amounts received as an annuity thereunder unless or until one of the following occurs:

(i) The contract is assigned or transferred for a valuable consideration (see section 72 (g) and paragraph (a) of § 1.72–10);

(ii) The contract matures or is surrendered, redeemed, or discharged in accordance with the provisions of paragraphs (c) and (d) of § 1.72–11;

(iii) The contract is exchanged (or is considered to have been exchanged) in a manner described in paragraph (e) of § 1.72–11.

(b) *Annuity starting date.*—(1) Except as provided in subparagraph (2) of this paragraph, the annuity starting date is the first day of the first period for which an amount is received as an annuity, except that if such date was before January 1, 1954, then the annuity starting date is January 1, 1954. The first day of the first period for which an amount is received as an annuity shall be whichever of the following is the later:

(i) The date upon which the obligations under the contract became fixed, or

(ii) The first day of the period (year, half-year, quarter, month, or otherwise, depending on whether payments are to be made annually, semiannually, quarterly, monthly, or otherwise) which ends on the date of the first annuity payment.

(2) Notwithstanding the provisions of subparagraph (1), the annuity starting date shall be determined in accordance with whichever of the following provisions is appropriate:

(i) In the case of a joint and survivor annuity contract described in section 72 (i) and paragraph (b) (3) of § 1.72–5, the annuity starting date is January 1, 1954, or the first day of the first period for which an amount is received as an annuity by the surviving annuitant, whichever is the later;

(ii) In the case of the transfer of an annuity contract for a valuable consideration, as described in section 72 (g) and paragraph (a) of § 1.72–10, the annuity starting date shall be January 1, 1954, or the first day of the first period for which the transferee received an amount as an annuity, whichever is the later; and

(iii) If the provisions of paragraph (e) of § 1.72–11 apply to an exchange of one contract for another, or to a transaction deemed to be such an exchange, the annuity starting date of the contract received (or deemed received) in exchange shall be January 1, 1954, or the first day of the first period for which an amount is received as an annuity under such contract, whichever is the later.

(c) *Fiscal year taxpayers.*—Fiscal year taxpayers receiving amounts as annuities in a taxable year to which the Internal Revenue Code of 1954 applies shall determine the annuity starting date in accordance with section 72 (c) (4) and this section. The annuity starting date for fiscal year taxpayers receiving amounts as an annuity in a taxable year to which the Internal Revenue Code of 1939 applies shall be January 1, 1954, except where the first day of the first period for which an amount is received by such a taxpayer as an annuity is

subsequent thereto and before the end of a fiscal year to which the Internal Revenue Code of 1939 applied. In such case, the latter date shall be the annuity starting date. In all cases where a fiscal year taxpayer received an amount as an annuity in a taxable year to which the Internal Revenue Code of 1939 applied and subsequent to the annuity starting date determined in accordance with the provisions of this paragraph, such amount shall be disregarded for the purposes of section 72 and the regulations thereunder.

(d) *Exceptions to the general rule.*—(1) Where the provisions of section 72 would otherwise require an exclusion ratio to be determined, but the investment in the contract (determined under § 1.72–6) is an amount of zero or less, no exclusion ratio shall be determined and all amounts received under such a contract shall be includible in the gross income of the recipient for the purposes of section 72.

(2) Where the investment in the contract is equal to or greater than the total expected return under such contract found under § 1.72–5, the exclusion ratio shall be considered to be 100 percent and all amounts received as an annuity under such contract shall be excludable from the recipient's gross income. See, for example, paragraph (f)(1) of § 1.72–5.

(3)(i) If a contract provides for payments to be made to a taxpayer in the manner described in paragraph (b)(3) of § 1.72–2, the investment in the contract shall be considered to be equal to the expected return under such contract and the resulting exclusion ratio (100%) shall be applied to all amounts received as an annuity under such contract. For any taxable year, payments received under such a contract shall be considered to be amounts received as an annuity only to the extent that they do not exceed the portion of the investment in the contract which is properly allocable to that year and hence excludable from gross income as a return of premiums or other consideration paid for the contract. The portion of the investment in the contract which is properly allocable to any taxable year shall be determined by dividing the investment in the contract (adjusted for any refund feature in the manner described in paragraph (d) of § 1.72–7) by the applicable multiple (whether for a term certain, life, or lives) which would otherwise be used in determining the expected return for such a contract under § 1.72–5. The multiple shall be adjusted in accordance with the provisions of the table in paragraph (a)(2) of § 1.72–5, if any adjustment is necessary, before making the above computation. If payments are to be made more frequently than annually and the number of payments to be made in the taxable year in which the annuity begins are less than the number of payments to be made each year thereafter, the amounts considered received as an annuity (as otherwise determined under this subdivision) shall not exceed, for such taxbale year (including a short taxable year), an amount which bears the same ratio to the portion of the investment in the contract considered allocable to each taxable year as the number of payments to be made in the first year bears to the number of payments to be made in each succeeding year. Thus, if payments are to be made monthly, only seven payments will be made in the first taxable year, and the portion of the investment in the contract allocable to a full year of payments is $600, the amounts considered received as an annuity in the first tax-

able year cannot exceed $350 ($600×7/12). See subdivision (iii) for an example illustrating the determination of the portion of the investment in the contract allocable to one taxable year of the taxpayer.

(ii) If subdivision (i) of this subparagraph applies to amounts received by a taxpayer and the total amount of payments he receives in a taxable year is less than the total amount excludable for such year under subdivision (i) of this subparagraph, the taxpayer may elect, in a succeeding taxable year in which he receives another payment, to redetermine the amounts to be received as an annuity during the current and succeeding taxable years. This shall be computed in accordance with the provisions of subdivision (i) of this subparagraph except that—

(*a*) The difference between the portion of the investment in the contract allocable to a taxable year, as found in accordance with subdivision (i) of this subparagraph, and the total payments actually received in the taxable year prior to the election shall be divided by the life expectancy of the annuitant (or annuitants), found in accordance with the appropriate table in § 1.72–9 (and adjusted in accordance with paragraph (a)(2) of § 1.72–5), or by the remaining term of a term certain annuity, computed as of the first day of the first period for which an amount is received as an annuity in the taxable year of the election; and

(*b*) The amount determined under (*a*) of this subdivision shall be added to the portion of the investment in the contract allocable to each taxable year (as otherwise found). To the extent that the total periodic payments received under the contract in the taxable year of the election or any succeeding taxable year does not equal this total sum, such payments shall be excludable from the gross income of the recipient. To the extent such payments exceed the sum so found, they shall be fully includible in the recipient's gross income.

See subdivision (iii) of this subparagraph for an example illustrating the redetermination of amounts to be received as an annuity and subdivision (iv) of this subparagraph for the method of making the election provided by this subdivision.

(iii) The application of the principles of this subparagraph may be illustrated by the following example:

Example. Taxpayer A, a 64 year old male, files his return on a calendar year basis and has a life expectancy of 15.6 years on June 30, 1954, the annuity starting date of a contract to which § 1.72–2(b)(3) applies and which he purchased for $20,000. The contract provides for variable annual payments for his life. He receives a payment of $1,000 on June 30, 1955, but receives no other payment until June 30, 1957. He excludes the $1,000 payment from his gross income for the year 1955 since this amount is less than $1,324.50, the amount determined by dividing his investment in the contract ($20,000) by his life expectancy adjusted for annual payments, 15.1 (15.6−.5), as of the original annuity starting date. Taxpayer A may elect, in his return for the taxable year 1957, to redetermine amounts to be received as an annuity under his contract as of June

30, 1956. For the purpose of determining the extent to which amounts received in 1957 or thereafter shall be considered amounts received as an annuity (to which a 100 percent exclusion ratio shall apply) he shall add $118.63 to the $1,324.50 originally determined to be receivable as an annuity under the contract, making a total of $1,443.13. This is determined by dividing the difference between what was excludable in 1955 and 1956, $2,649 (2×$1,324.50) and what he actually received in those years ($1,000) by his life expectancy adjusted for annual payments, 13.9 (14.4−.5), as of his age at his nearest birthday (66) on the first day of the first period for which he received an amount as an annuity in the taxable year of election (June 30, 1956). The result, $1,443.13, is excludable in that year and each year thereafter as an amount received as an annuity to which the 100% exclusion ratio applies. It will be noted that in this example the taxpayer received amounts less than the excludable amounts in two successive years and deferred making his election until the third year, and thus was able to accumulate the portion of the investment in the contract allocable to each taxable year to the extent he failed to receive such portion in both years. Assuming that he received $1,500 in the taxable year of his election, he would include $56.87 in his gross income and exclude $1,443.13 therefrom for that year.

(iv) If the taxpayer chooses to make the election described in subdivision (ii), he shall file with his return a statement that he elects to make a redetermination of the amounts excludable from gross income under his annuity contract in accordance with the provisions of paragraph (d)(3) of § 1.72-4. This statement shall also contain the following information:

(*a*) The original annuity starting date and his age on that date,

(*b*) The date of the first day of the first period for which he received an amount in the current taxable year,

(*c*) The investment in the contract originally determined (as adjusted for any refund feature), and

(*d*) The aggregate of all amounts received under the contract between the date indicated in (*a*) of this subdivision and the day after the date indicated in (*b*) of this subdivision to the extent such amounts were excludable from gross income.

He shall include in gross income any amounts received during the taxable year for which the return is made in accordance with the redetermination made under this subparagraph.

(e) *Exclusion ratio in the case of two or more annuity elements acquired for a single consideration.*—(1) (i) Where two or more annuity elements are provided under a contract described in paragraph (a)(2) of § 1.72-2, an exclusion ratio shall be determined for the contract as a whole and applied to all amounts received as an annuity under any of the annuity elements. To obtain this ratio, the investment in the contract determined in accordance with § 1.72-6 shall be divided by the aggregate of the expected returns found with respect to each of the annuity elements in accordance with § 1.72-5. For this purpose, it is immaterial that payments under one or more of the annuity elements involved have not commenced at the time when an amount is first re-

ceived as an annuity under one or more of the other annuity elements.

(ii) The exclusion ratio found under subdivision (i) of this subparagraph does not apply to—

(*a*) An annuity element payable to a surviving annuitant under a joint and survivor annuity contract to which section 72(i) and paragraphs (b) (3) and (e) (3) of § 1.72–5 apply, or to

(*b*) A contract under which one or more of the constituent annuity elements provides for payments described in paragraph (b) (3) of § 1.72–2.

For rules with respect to a contract providing for annuity elements described in (*b*) of this subdivision, see subparagraph (2) of this paragraph.

(2) If one or more of the annuity elements under a contract described in paragraph (a) (2) of § 1.72–2 provides for payments to which paragraph (b) (3) of § 1.72–2 applies—

(i) With respect to the annuity elements to which paragraph (b) (3) of § 1.72–2 does not apply, an exclusion ratio shall be determined by dividing the portion of the investment in the entire contract which is properly allocable to all such elements (in the manner provided in paragraph (b) (3) (ii) of § 1.72–6) by the aggregate of the expected returns thereunder and such ratio shall be applied in the manner described in subdivision (i) of subparagraph (1); and

(ii) With respect to the annuity elements to which paragraph (b) (3) of § 1.72–2 does apply, the investment in the entire contract shall be reduced by the portion thereof found in subdivision (i) of this subparagraph and the resulting amount shall be used to determine the extent to which the aggregate of the payments received during the taxable year under all such elements is excludable from gross income. The amount so excludable shall be allocated to each recipient under such elements in the same ratio that the total of the payments he receives each year bears to the total of the payments received by all such recipients during the year. The exclusion ratio with respect to the amounts so allocated shall be 100 percent. See paragraph (f) (2) of § 1.72–5 and paragraph (b) (3) of § 1.72–6.

§ 1.72–5 Expected Return.—(a) *Expected return for but one life.*—(1) If a contract to which section 72 applies provides that one annuitant is to receive a fixed monthly income for life, the expected return is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table I of § 1.72–9 under the age (as of annuity starting date) and sex of the measuring life (usually the annuitant's). Thus, where a male purchases a contract providing for an immediate annuity of $100 per month for his life and, as of the annuity starting date (in this case the date of purchase), the annuitant's age at his nearest birthday is 66, the expected return is computed as follows:

Monthly payment of $100×12 months equals annual payment of	$1,200
Multiple shown in Table I, male, age 66	14.4
Expected return ($1,200×14.4)	$17,280

(2) (i) If payments are to be made quarterly, semiannually, or annually, an adjustment of the applicable multiple shown in Table I

may be required. A further adjustment may be required where the interval between the annuity starting date and the date of the first payment is less than the interval between future payments. Neither adjustment shall be made, however, if the payments are to be made more frequently than quarterly. The amount of the adjustment, if any, is to be found in accordance with the following table:

If the number of whole months from the annuity starting date to the first payment date is	0–1	2	3	4	5	6	7	8	9	10	11	12
And payments under the contract are to be made:												
Annually	+0.5	+0.4	+0.3	+0.2	+0.1	0	0	−0.1	−0.2	−0.3	−0.4	−0.5
Semiannually	+.2	+.1	0	0	−.1	−.2						
Quarterly	+.1	0	−.1									

Thus, for a male, age 66, the multiple found in Table I adjusted for quarterly payments the first of which is to made one full month after the annuity starting date, is 14.5 (14.4+.1); for semiannual payments the first of which is to be made six full months from the annuity starting date, the adjusted multiple is 14.2 (14.4−.2); for annual payments the first of which is to be made one full month from the annuity starting date, the adjusted multiple is 14.9 (14.4+.5). If the annuitant in the example shown in subparagraph (1) of this paragraph were to receive an annual payment of $1,200 commencing 12 full months after his annuity starting date, the amount of the expected return would be $16,680 ($1,200×13.9 [14.4−.5]).

(ii) Notwithstanding the table in subdivision (i) of this subparagraph, adjustments of multiples for early or other than monthly payments determined prior to February 19, 1956, under the table prescribed in subparagraph (a)(4) of paragraph (1) of T. D. 6118, approved December 30, 1954, need not be redetermined.

(3) If the contract provides for fixed payments to be made to an annuitant until death or until the expiration of a specified limited period, whichever occurs earlier, the expected return of such temporary life annuity is determined by multiplying the total of the annuity payments to be received annually by the multiple shown in Table IV of § 1.72–9 for the age (as of the annuity starting date) and sex of the annuitant and the nearest whole number of years in the specified period. For example, if a male annuitant, age 60 (at his nearest birthday), is to receive $60 per month for five years or until he dies, whichever is earlier, the expected return under such a contract is $3,456, computed as follows:

Monthly payments of $60×12 months equals annual payment of	$720
Multiple shown in Table IV for male, age 60, for term of 5 years	4.8
Expected return for 5 year temporary life annuity of $720 per year ($720×4.8)	$3,456

The adjustment provided by subparagraph (2) of this paragraph shall not be made with respect to the multiple found in Table IV.

(4) If the contract provides for payments to be made to an annuitant for his lifetime, but the amount of the annual payments is to be decreased after the expiration of a specified limited period, the expected return is computed by considering the contract as a combination of a whole life annuity for the smaller amount plus a temporary life annuity for an amount equal to the difference between the larger and the smaller amount. For example, if a male annuitant, age 60, is to receive $150 per month for five years or until his earlier death, and is to receive $90 per month for the remainder of his lifetime after such five years, the expected return is computed as if the annuitant's contract consisted of a whole life annuity for $90 per month plus a five year temporary life annuity of $60 per month. In such circumstances, the expected return is computed as follows:

Monthly payments of $90×12 months equals annual payment of	$1, 080
Multiple shown in Table I for male, age 60	18. 2
Expected return for whole life annuity of $1,080 per year	$19, 656
Expected return for 5 year temporary life annuity of $720 per year (as found in subparagraph (3))	3, 456
Total expected return	$23, 112

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(5) If the contract described in subparagraph (4) of this paragraph provided that the amount of the annual payments to the annuitant were to be increased (instead of decreased) after the expiration of a specified limited period, the expected return would be computed as if the annuitant's contract consisted of a whole life annuity for the larger amount minus a temporary life annuity for an amount equal to the difference between the larger and smaller amount. Thus, if the annuitant described in subparagraph (4) of this paragraph were to receive $90 per month for five years or until his earlier death, and to receive $150 per month for the remainder of his lifetime after such five years, the expected return would be computed by subtracting the expected return under a five year temporary life annuity of $60 per month from the expected return under a whole life annuity of $150 per month. In such circumstances, the expected return is computed as follows:

Monthly payments of $150×12 months equals annual payment of	$1, 800
Multiple shown in Table I (male, age 60)	18. 2
Expected return for annuity for whole life of $1,800 per year	$32, 760
Less expected return for 5 year temporary life annuity of $720 per year (as found in subparagraph (3))	3, 456
Net expected return	$29, 304

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table I for the whole life annuity should be made in accordance with subparagraph (2) of this paragraph.

(b) *Expected return under joint and survivor and joint annuities.*—(1) In the case of a joint and survivor annuity contract involving two annuitants which provides the first annuitant with a fixed monthly income for life and, after the death of the first annuitant, provides an identical monthly income for life to a second annuitant, the expected return shall be determined by multiplying the total amount of the payments to be received annually by the multiple obtained from Table II of § 1.72–9 under the ages (as of the annuity starting date) and sexes of the living annuitants. For example, a husband purchases a joint and survivor annuity contract providing for payments of $100 per month for life, and, after his death, for the same amount to his wife for the remainder of her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. The expected return is computed as follows:

Monthly payments of $100×12 months equals annual payment of	$1, 200
Multiple shown in Table II (male, age 70; female, age 67)	19. 7
Expected return ($1,200×19.7)	$23, 640

If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table II should be made in accordance with paragraph (a)(2) of this section.

(2) If a contract of the type described in subparagraph (1) of this paragraph provides that a different (rather than an identical) monthly income is payable to the second annuitant, the expected return is computed in the following manner. The applicable multiple in Table II is first found as in the example in subparagraph (1) of this paragraph. The multiple applicable to the first annuitant is then found in Table I as though the contract were for a single life annuity. The multiple from Table I is then subtracted from the multiple obtained from Table II and the resulting multiple is applied to the total payments to be received annually under the contract by the second annuitant. The result is the expected return with respect to the second annuitant. The portion of the expected return with respect to payments to be made during the first annuitant's life is then computed by applying the multiple found in Table I to the total annual payments to be received by such annuitant under the contract. The expected returns with respect to each of the annuitants separately are then aggregated to obtain the expected return under the entire contract.

Example. A husband purchases a joint and survivor annuity providing for payments of $100 per month for his life and, after his death, payments to his wife of $50 per month for her life. As of the annuity starting date his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67.

Multiple from Table II (male, age 70; female, age 67)	19.7
Multiple from Table I (male, age 70)	12.1
Difference (multiple applicable to second annuitant)	7.6
Portion of expected return, second annuitant ($600×7.6)	$4,560
Portion of expected return, first annuitant ($1,200×12.1)	$14,520
Expected under the contract	$19,080

The expected return thus found, $19,080, is to be used in computing the amount to be excluded from gross income. Thus, if the investment in the contract in this example is $14,310, the exclusion ratio is $\frac{\$14{,}310}{\$19{,}080}$, or 75 percent. The amount excludable from each monthly payment made to the husband is 75 percent of $100, or $75, and the remaining $25 of each payment received by him shall be included in his gross income. After the husband's death, the amount excludable by the second annuitant (the surviving wife) would be 75 percent of each monthly payment of $50, or $37.50, and the remaining $12.50 of each payment shall be included in her gross income.

The same method is used if the payments are to be increased after the death of the first annuitant. Thus, if the payments to be made until the husband's death were $50 per month and his widow were to receive $100 per month thereafter until her death, the 7.6 multiple in the above example would be applied to the $100 payments, yielding an expected return with respect to this portion of the annuity contract of $9,120 ($1,200×7.6). An expected return of $7,260 ($600×12.1) would be obtained with respect to the payments to be made the husband, yielding a total expected return under the contract of $16,380 ($9,120 plus $7,260). If payments are to be made quarterly, semiannually, or annually, an appropriate adjustment of the multiples found in Tables I and II should be made in accordance with paragraph (a)(2) of this section.

(3) In the case of a joint and survivor annuity contract in respect of which the first annuitant died in 1951, 1952, or 1953, and the basis of the surviving annuitant's interest in the contract was determinable under section 113(a)(5) of the Internal Revenue Code of 1939, such basis shall be considered the "aggregate of premiums or other consideration paid" by the surviving annuitant for the contract. (For rules governing this determination, see 26 CFR (1939) §§ 39.22(b)(2)-2 and 39.113(a)(5)-1 [Regulations 118].) In determining such an annuitant's investment in the contract, such aggregate shall be reduced by any amounts received under the contract by the surviving annuitant before the annuity starting date, to the extent such amounts were excludable from his gross income at the time of receipt. The expected return of the surviving annuitant in such cases shall be determined in the manner prescribed in paragraph (a) of this section, as though the surviving annuitant alone were involved. For this purpose, the appropriate multiple for the survivor shall be obtained from Table I as of the annuity starting date determined in accordance with paragraph (b)(2)(i) of § 1.72-4.

(4) If a contract involving two annuitants provides for fixed monthly payments to be made as a joint life annuity until the death of the first annuitant to die (in other words, only as long as both remain alive), the expected return under such contract shall be determined by multiplying the total of the annuity payments to be received annually under the contract by the multiple obtained from Table IIA of § 1.72–9 under the ages (as of the annuity starting date) and sexes of the annuitants. If, however, payments are to be made under the contract quarterly, semiannually, or annually, an appropriate adjustment of the multiple found in Table IIA shall be made in accordance with paragraph (a) (2) of this section.

(5) If a joint and survivor annuity contract involving two annuitants provides that a specified amount shall be paid during their joint lives and a different specified amount shall be paid to the survivor upon the death of whichever of the annuitants is the first to die, the following preliminary computation shall be made in all cases preparatory to determining the expected return under the contract:

(i) From Table II, obtain the multiple under both of the annuitants' ages (as of the annuity starting date) and their appropriate sexes;

(ii) From Table IIA, obtain the multiple applicable to both annuitants' ages (as of the annuity starting date) and their appropriate sexes;

(iii) Apply the multiple found in subdivision (i) of this subparagraph to the total of the amounts to be received annually after the death of the first to die; and

(iv) Apply the multiple found in subdivision (ii) of this subparagraph to the difference between the total of the amounts to be received annually before and the total of the amounts to be received annually after the death of the first to die.

If the original annual payment is in excess of the annual payment to be made after the death of the first to die, the expected return is the sum of the amounts determined under subdivisions (iii) and (iv) of this subparagraph. This may be illustrated by the following example:

Example. A husband purchases a joint and survivor annuity providing for payments of $100 a month for as long as both he and his wife live, and, after the death of the first to die, payments to the survivor of $75 a month for life. As of the annuity starting date, his age at his nearest birthday is 70 and that of his wife at her nearest birthday is 67. The expected return under the contract is computed as follows:

Multiple from Table II (male, age 70; female, age 67)	19.7
Multiple from Table IIA (male, age 70; female, age 67)	9.3
Portion of expected return ($900×19.7—sum per year after first death)	$17,730
Portion of expected return ($300×9.3—amount of change in sum at first death)	$ 2,790
Expected return under the contract	$20,520

The total expected return in this example, $20,520, is to be used in computing the amount to be excluded from gross income. Thus,

if the investment in the contract is $17,887, the exclusion ratio is $\frac{\$17,887}{\$20,520}$, or 87.2 percent. The amount excludable from each monthly payment made while both are alive is 87.2 percent of $100, or $87.20 and the remaining $12.80 of each payment shall be included in gross income. After the death of the first to die, the amount excludable by the survivor shall be 87.2 percent of each monthly payment of $75, or $65.40, and the remaining $9.60 of each payment shall be included in gross income.

If the original annual payment is less than the annual payment to be made after the death of the first to die, the expected return is the difference between the amounts determined under subdivisions (iii) and (iv), above. If, however, payments are to be made quarterly, semiannually, or annually under the contract, the multiples obtained from both Tables II and IIA shall first be adjusted in a manner prescribed in paragraph (a)(2) of this section.

(6) If a contract provides for the payment of life annuities to two persons during their respective lives and, after the death of one (without regard to which one dies first), provides that the survivor shall receive for life both his own annuity payments and the payments made formerly to the deceased person, the expected return shall be determined in accordance with paragraph (e)(4) of this section.

(7) If paragraph (b)(3) of § 1.72–2 applies to payments provided under a contract and this paragraph applies to such payments, the principles of this paragraph shall be used in making the computations described in paragraph (d)(3) § 1.72–4. This may be illustrated by the following examples:

Example (1). Taxpayer A, a male age 63, pays $24,000 for a contract which provides that the proceeds (both income and return of capital) from eight units of an investment fund shall be paid monthly to him for his life and that after his death the proceeds from six such units shall be paid monthly to B, a female age 55, for her life, the portion of the investment in the contract allocable to each taxable year of A is $955.20 and that allocable to each taxable year of B is $716.40. This is determined in the following manner:

Multiple from Table II (male, age 63; and female, age 55)	28.1	
Number of units to be paid, in effect, as a joint and survivor annuity	6	
Number of total annual unit payments anticipatable with respect to the joint and survivor annuity element		168.6
Multiple from Table I (male, age 63)	16.2	
Number of units to be paid in effect, as a single life annuity	2	
Number of total annual unit payments anticipatable with respect to A alone		32.4
Total number of unit payments anticipatable		201
Portion of investment in the contract allocable to unit payments ($24,000÷201) on an annual basis	$119.40	
Number of units payable to A while he continues to live	8	

Portion of the investment in the contract allocable to each taxable year of A		$955.20
Portion of investment in the contract allocable to unit payments ($24,000÷201) on an annual basis	$119.40	
Number of units payable to B for her life after A's death	6	
Portion of the investment in the contract allocable to each taxable year of B		$716.40

For the purpose of the above computation it is immaterial whether or not A lives to or beyond the life expectancy shown for him in Table I.

Example (2). Assume that Taxpayer A in example (1) receives payments for five years which are at least as large as the portion of the investment in the contract allocable to such years, but in the sixth year he receives a total on only $626.40 rather than the $955.20 allocable to such year. A is 69 and B is 61 at the beginning of the first monthly period for which an amount is payable in the seventh taxable year. A makes the election in that year provided under § 1.72-4(d)(3). The difference between the portion of the investment in the contract allocable to the sixth year and the amount actually received in that year is $328.80 ($955.20 less $626.40). In this case, 139.2 unit payments are anticipatable (on an annual basis), since the appropriate multiple from Table II of § 1.72-9, 23.2, multiplied by the number of units payable, in effect, as a joint and survivor annuity yields this result (6×23.2). A's appropriate multiple from Table I of § 1.72-9 for the two units which will cease to be paid at his death is 12.6, and the total number of unit payments anticipatable (on an annual basis) is, therefore, 164.4 (2×12.6 plus 139.2). Dividing the difference previously found ($328.80) by the total number of unit payments thus determined (164.4) indicates that A will have an additional allocation of the investment in the contract of $16 to the seventh and every succeeding full taxable year (8 units×$2), and B will have an additional allocation of the investment in the contract of $12 (6 units×$2) to each taxable year in which she receives 12 monthly payments subsequent to the death of A. The total allocable to each taxable year of A is, therefore, $971.20, and that allocable to each taxable year of B will be $728.40.

Example (3). If, in example (2), A had died at the end of the fifth year, in the sixth year B would have received a payment of $469.80 (that portion of the $626.40 that A would have received which is in the same ratio that 6 units bear to 8 units) and would thus have received $246.60 less than the portion of the investment in the contract originally determined to be allocable to each of her taxable years. In these circumstances, B would be entitled to elect to redetermine the portion of the investment in the contract allocable to the taxable year of election and all subsequent years. The new amount allocable thereto would be found by dividing the $246.60 difference by her life expectancy as of the first day of the first period for which she received an amount as an annuity in the seventh year of the annuity contract, and adding the result to her originally determined allocation of $716.40.

(c) *Expected return for term certain.*—In the case of a contract

providing for specific periodic payments which are to be paid for a term certain such as a fixed number of months or years, without regard to life expectancy, the expected return is determined by multiplying the fixed number of years or months for which payments are to be made on or after the annuity starting date by the amount of the payment provided in the contract for each such period.

(d) *Expected return with respect to amount certain.*—In the case of contracts involving no life or lives as a measurement of their duration, but under which a determinable total amount is to be paid in installments of lesser amounts paid at periodic intervals, the expected return shall be the total amount guaranteed. If an amount is to be paid periodically until a fund plus interest at a fixed rate is exhausted, but further payments may be made thereafter because of earnings at a higher interest rate, this paragraph shall apply to the total amount anticipatable as a result of the amount of the fund plus the fixed interest thereon. Any amount which may be paid as the result of earnings at a greater interest rate shall be disregarded in determining the expected return. If such an amount is later received, it shall be considered an amount not received as an annuity after the annuity starting date. See paragraph (b) (2) of § 1.72–11.

(e) *Expected return where two or more annuity elements providing for fixed payments are acquired for a single consideration.*—(1) In the case of a contract described in paragraph (a) (2) of § 1.72–2, which provides for specified payments to be made under two or more annuity elements, the expected return shall be found for the contract as a whole by aggregating the expected returns found with respect to each annuity element. If individual life annuity elements are involved (including joint and survivor annuities where the primary annuitant died before January 1, 1954), expected return for each of them shall be determined in the manner prescribed in paragraph (a) of this section. If joint and survivor annuity elements are involved, the expected return for such elements shall be determined under the appropriate subparagraph of paragraph (b) of this section. If terms certain or amounts certain are involved, the expected returns for such elements shall be determined under paragraph (c) or (d) of this section, respectively.

(2) The aggregate expected return found in accordance with the rules set forth in subparagraph (1) shall constitute the expected return for the contract as a whole. The investment in the contract shall be divided by the amount thus determined to obtain the exclusion ratio for the contract as a whole. This exclusion ratio shall be applied to all amounts received as an annuity under the contract by any recipient (in accordance with the provisions of § 1.72–4), except in the case of amounts received by a surviving annuitant under a joint and survivor annuity element to which the provisions of section 72(i) and paragraph (b) (3) of this section would apply if it were a separate contract. See subparagraph (3) of this paragraph.

(3) In the case of a contract providing two or more annuity elements, one of which is a joint and survivor annuity element of the type described in section 72(i) and paragraph (b) (3) of this section, the general exclusion ratio for the contract as a whole, for the purpose of computations with respect to all the other annuity elements, shall be

determined in accordance with the principles of subparagraphs (1) and (2) of this paragraph. A special exclusion ratio shall thereafter be determined for the surviving annuitant receiving payments under the annuity element described in section 72(i) and paragraph (b)(3) of this section by using the investment in the contract and the expected return determined in accordance with the provisions of paragraph (b)(3) of this section.

(4) In the case of a contract providing for payments to be made to two persons in the manner described in paragraph (b)(6) of § 1.72–5, the expected return is to be computed as though there were two joint and survivor annuities under the same contract, in the following manner. First, the multiple appropriate to the ages (as of the annuity starting date) and sexes of the annuitants involved shall be found in Table II of § 1.72–9 and adjusted, if necessary, in the manner described in paragraph (a)(2) of this section. Second, the multiple so found shall be applied to the sum of the payments to be made each year to both annuitants. The result is the expected return for the contract as a whole.

(5) For rules relating to expected return where two or more annuity elements are acquired for a single consideration and one or more of such elements does not specify a fixed payment for each period, see paragraph (f) of this section.

(f) *Expected return with respect to obligations providing for payments described in paragraph (b) (3) of § 1.72–2.*—(1) If a contract to which section 72 applies provides only for payments to be made in a manner described in paragraph (b)(3) of § 1.72–2, the expected return for such contract as a whole shall be an amount equal to the investment in the contract found in accordance with section 72(c)(1) and § 1.72–6, as adjusted for any refund feature in accordance with § 1.72–7.

(2) If a contract to which section 72 applies provides for annuity elements, one or more of which (but not all) provide for payments to be made in a manner described in paragraph (b)(3) of § 1.72–2—

(i) With respect to the portion of the contract providing for annuity elements to which paragraph (b)(3) of § 1.72–2 does not apply, the expected return shall be the aggregate of the expected returns found for each of such elements in accordance with the appropriate paragraph of this section; and

(ii) With respect to all annuity elements to which paragraph (b)(3) of § 1.72–2 does apply, the expected return for all such elements shall be an amount equal to the portion of the investment in the contract allocable to such elements in accordance with the provisions of paragraph (e)(2)(ii) of § 1.72–4 and paragraph (b)(3)(ii)(*b*) of § 1.72–6.

§ 1.72–6 Investment in the Contract.—(a) *General rule.*—(1) For the purpose of computing the "investment in the contract", it is first necessary to determine the "aggregate amount of premiums or other consideration paid" for such contract. See section 72(c)(1). This determination is made as of the later of the annuity starting date of the contract or the date on which an amount is first received thereunder as an annuity. The amount so found is then reduced by the

sum of the following amounts in order to find the investment in the contract:

(i) The total amount of any return of premiums or dividends received (including unrepaid loans or dividends applied against the principal or interest on such loans) on or before the date on which the foregoing determination is made, and

(ii) The total of any other amounts received with respect to the contract on or before such date which were excludable from the gross income of the recipient under the income tax law applicable at the time of receipt.

Amounts to which subdivision (ii) applies shall include, for example, amounts considered to be return of premiums or other consideration paid under section 22(b)(2) of the Internal Revenue Code of 1939 and amounts considered to be an employer-provided death benefit under section 22(b)(1)(B) of such Code. For rules relating to the extent to which an employee or his beneficiary may include employer contributions in the aggregate amount of premiums or other consideration paid, see § 1.72–8.

(2) For the purpose of subparagraph (1), amounts received subsequent to the receipt of an amount as an annuity or subsequent to the annuity starting date, whichever is the later, shall be disregarded. See, however, § 1.72–11.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). In 1950, B purchased an annuity contract for $10,000 which was to provide him with an annuity of $1,000 per year for life. He received $1,000 in each of the years 1950, 1951, 1952, and 1953, prior to the annuity starting date (January 1, 1954). Under the Internal Revenue Code of 1939, $300 of each of these payments (3% of $10,000) was includible in his gross income, and the remaining $700 was excludable therefrom during each of the taxable years mentioned. In computing B's investment in the contract as of January 1, 1954, the total amount excludable from his gross income during the years 1950 through 1953 ($2,800) must be substracted from the consideration paid ($10,000). Accordingly, B's investment in the contract as of January 1, 1954, is $7,200 ($10,000 less $2,800).

Example (2). In 1945, C contracted for an annuity to be paid to him beginning December 31, 1960. In 1945 and in each successive year until 1960, he paid a premium of $5,000. Assuming he receives no payments of any kind under the contract until the date on which he receives the first annual payment as an annuity (December 31, 1960), his investment in the contract as of the annuity starting date (December 31, 1959) will be $75,000 ($5,000 paid each year for the 15 years from 1945 to 1959, inclusive).

Example (3). Assume the same facts as in example (2), except that prior to the annuity starting date C has already received from the insurer dividends of $1,000 each in 1949, 1954, and 1959, such dividends not being includible in his gross income in any of those years. C's investment in the contract, as of the annuity starting date, will then be $72,000 ($75,000–$3,000).

416926°—57——4

(b) *Allocation of the investment in the contract where two or more annuity elements are acquired for a single consideration.*—(1) In the case of a contract described in § 1.72–2(a)(2) which provides for two or more annuity elements, the investment in the contract determined under paragraph (a) shall be allocated to each of the annuity elements in the ratio that the expected return under each annuity element bears to the aggregate of the expected returns under all the annuity elements. The exclusion ratio for the contract as a whole shall be determined by dividing the investment in the contract (after adjustment for the present value of any or all refund features) by the aggregate of the expected returns under all the annuity elements. Thus, if a contract provides for annuity payments of $1,000 per year for life (with no refund feature) to both A and B, a male and female, respectively, each 70 years of age as of the annuity starting date, and such contract is acquired for consideration of $19,575 (without regard to whether paid by A, B, or both), the investment in the contract shall be allocated by determining the exclusion ratio for the contract as a whole in the following manner:

Expectancy of A under Table I and § 1.72–5(a)(2), 11.6 (12.1—.5), multiplied by $1,000	$11,600
Expectancy of B computed in a similar manner ($1,000×14.5 [15.0—.5])	14,500
Total expected return	$26,100

The exclusion ratio for both A and B is then $\frac{\$19,575}{\$26,100}$, or 75 percent. A and B shall each exclude from gross income three-fourths ($750) of each $1,000 annual payment received and shall include the remaining one-fourth ($250) of each $1,000 annual payment received in gross income.

(2) In the case of a contract providing for specified annual annuity payments to be made to two persons during their joint lives and the payment of the aggregate of the two individual payments to the survivor for his life, the investment in the contract shall be allocated in accordance with the provisions of subparagraph (1). For this purpose, the investment in the contract (without regard to the fact that differing amounts may have been contributed by the two annuitants) shall be divided by the expected return determined in accordance with § 1.72–5(e)(4). The resulting exclusion ratio shall then be applied to any amounts received as an annuity by either annuitant.

(3) In the case of a contract providing two or more annuity elements, one or more of which provides for payments to be made in a manner described in paragraph (b)(3) of § 1.72–2, the investment in the contract shall be allocated to the various annuity elements in the following manner:

(i) If all the annuity elements provide for payments to be made in the manner described in paragraph (b)(3) of § 1.72–2, the investment in the contracts shall be allocated on the basis of the amounts received by each recipient by apportioning the amount determined to be excludable under that section to each recipient in the same ratio as the total of the amounts received by him in his taxable year

bears to the total of the amounts received by all recipients during the same period; and

(ii) If one or more, but not all, of the annuity elements provide for payments to be made in a manner described in paragraph (b) (3) of § 1.72–2—

(*a*) With respect to all annuity elements to which that section does not apply, the investment in the contract for all such elements shall be the portion of the investment in the contract as a whole (found in accordance with the provisions of this section) which is properly allocable to all such elements; and

(*b*) With respect to all annuity elements to which paragraph (b) (3) of § 1.72–2 does apply, the investment in the contract for all such elements shall be the investment in the contract as a whole (found in accordance with the provisions of this section) as reduced by the portion thereof determined under subdivision (*a*) of this subdivision.

For the purpose of determining, pursuant to (*a*) of this subdivision, the portion of the investment in the contract as a whole properly allocable to a particular annuity element, reference shall be made to the present value of such annuity element determined in accordance with paragraph (e) (1) (iii) (*b*) of § 1.101–2.

(c) *Special rules.*—(1) For the special rule for determining the investment in the contract for a surviving annuitant in cases where the prior annuitant of a joint and survivor annuity contract died in 1951, 1952, or 1953, see paragraph (b) (3) of § 1.72–5.

(2) For special rules relating to the determination of the investment in the contract where employer contributions are involved, see § 1.72–8. See also paragraph (a) (3) (i) of § 1.402(a)–1 for a special rule relating to the determination of the premiums or other consideration paid for a contract where an employee is taxable on the premiums paid for life insurance protection that is purchased by and considered to be a distribution from an exempt employees' trust.

(3) For the determination of an adjustment in investment in the contract in cases where a contract contains a refund feature, see § 1.72–7.

§ 1.72–7 Adjustment in Investment Where a Contract Contains a Refund Feature.—(a) *Definition of a contract containing a refund feature.*—A contract to which section 72 applies, contains a refund feature if—

(1) The total amount receivable as an annuity under such contract depends, in whole or in part, on the continuing life of one or more persons,

(2) The contract provides for payments to be made to a beneficiary or the estate of an annuitant on or after the death of the annuitant if a specified amount or a stated number of payments has not been paid to the annuitant or annuitants prior to death, and

(3) Such payments are in the nature of a refund of the consideration paid. See paragraph (c) (1) of § 1.72–11.

(b) *Adjustment of investment for the refund feature in the case of a single life annuity.*—Where a single life annuity contract to which

section 72 applies contains a refund feature and the special rule of paragraph (d) does not apply, the investment in the contract shall be adjusted in the following manner:

(1) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract to the extent such amount reduces the guaranteed amount. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(2) Consult Table III of § 1.72–9 for the appropriate percentage under the whole number of years found in (1) and the age (as of the annuity starting date) and sex of the annuitant.

(3) Multiply the percentage found in (2) by whichever of the following is the smaller: (i) the investment in the contract found in accordance with § 1.72–6 or (ii) the total amount guaranteed as of the annuity starting date.

(4) Subtract the amount found in subparagraph (3) of this paragraph from the investment in the contract found in accordance with § 1.72–6.

The resulting amount is the investment in the contract adjusted for the present value of the refund feature without discount for interest and is to be used in determining the exclusion ratio to be applied to the payments received as an annuity. The percentage found in Table III shall not be adjusted in a manner described in paragraph (a)(2) of § 1.72–5. These principles may be illustrated by the following example:

Example. On January 1, 1954, a husband, age 65, purchased for $21,053, an immediate installment refund annuity payable $100 per month for life. The contract provided that in the event the husband did not live long enough to recover the full purchase price, payments were to be made to his wife until the total payments under the contract equaled the purchase price. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)		$21, 053
Amount to be received annually	$1, 200	
Number of years for which payment guaranteed ($21,053 divided by $1,200)	17. 5	
Rounded to nearest whole number of years	18	
Percentage located in Table III for age 65 (age of the annuitant as of the annuity starting date) and 18 (the number of whole years)	30%	
Subtract value of the refund feature to the nearest dollar (30% of $21,053)		$6, 316
Investment in the contract adjusted for the present value of the refund feature without discount for interest		$14, 737

If, in the above example, the guaranteed amount had exceeded the investment in the contract, the percentage found in Table III should

have been applied to the lesser of these amounts since any excess of the guaranteed amount over the investment in the contract (as found under § 1.72–6) would not have constituted a refund of premiums or other consideration paid. In such a case, however, a different multiple might have been obtained from Table III since the number of years for which payments were guaranteed would have been greater.

(c) *Adjustment of investment for the refund feature in the case of a joint and survivor annuity.*—(1) Where a joint and survivor annuity contract described in paragraph (b)(1) or (6) of § 1.72–5 contains a refund feature and the special rule of paragraph (d) does not apply, the investment in the contract shall be adjusted in the following manner:

(i) Determine the number of years necessary for the guaranteed amount to be fully paid by dividing the maximum amount guaranteed as of the annuity starting date by the amount to be received annually under the contract. The number of years should be stated in terms of the nearest whole year, considering for this purpose a fraction of one-half or more as an additional whole year.

(ii) Consult Table III of § 1.72–9 for the appropriate percentages under the whole number of years found in (i) and the age (as of the annuity starting date) and sex of each annuitant. If the annuitants are not of the same sex, substitute for the female annuitant a male annuitant 5 years younger, or for the male annuitant a female annuitant 5 years older, so that Table III will be entered in both cases with the ages of annuitants of the same sex.

(iii) Find the sum of the two percentages found in accordance with subdivision (ii) of this subparagraph.

(iv) To the age of the elder of the two annuitants (as determined under subdivision (ii) of this subparagraph), add the number of years (indicated in the table below) opposite the number of years by which such annuitants' ages differ:

Number of years difference in age (two male annuitants or two female annuitants)	Addition to older age in years
0 to 1, inclusive	9
2 to 3, inclusive	8
4 to 5, inclusive	7
6 to 8, inclusive	6
9 to 11, inclusive	5
12 to 15, inclusive	4
16 to 20, inclusive	3
21 to 27, inclusive	2
28 to 42, inclusive	1
Over 42	0

(v) Consult Table III for the appropriate percentage under the whole number of years found in subdivision (i) and the sex and age of the elder annuitant as adjusted under subdivision (iv) of this subparagraph.

(vi) Subtract the percentage obtained in subdivision (v) of this subparagraph from the sum of the percentages found under subdivision (iii) of this subparagraph. If the result is less than one, subdivisions (vii) and (viii) of this subparagraph shall be disregarded and no adjustment made to the investment in the contract.

(vii) Multiply the percentage found in subdivision (vi) of this subparagraph by whichever of the following is the smaller: (*a*) the investment in the contract found in accordance with § 1.72–6 or (*b*) the total amount guaranteed as of the annuity starting date.

(viii) Subtract the amount found in subdivision (vii) of this subparagraph from the investment in the contract found in accordance with § 1.72–6.

(2) The computation provided in subparagraph (1) of this paragraph for a case to which it applies may be illustrated by the following example:

Example. A husband, age 70, purchases a joint and last survivor annuity for $33,050. The contract provides for payments of $100 a month to be paid first to himself for life and then to B, his 40-year old daughter, if she survives him. The contract further provides that in the event both die before ten years' payments have been made, payments will be continued to C, a beneficiary, or to C's estate, until ten years' payments have been made. The investment in the contract adjusted for the purpose of determining the exclusion ratio is computed in the following manner:

Cost of the annuity contract (investment in the contract, unadjusted)		$33, 050
Guaranteed amount ($1,200×10)	$12, 000	
Percentage in Table III for male, age 70 (or female, age 75) for duration of the guarantee (10)	21%	
Percentage in Table III for female, age 40 (or male, age 35) for duration of the guarantee (10)	2%	
Sum of percentages obtained	23%	
Difference in years of age between two males, age 70 and 35 (or two females, aged 75 and 40)	35	
Addition, in years, to older age	1	
Percentage in Table III for male one year older than the huband	22%	
Difference between percentages obtained (23% less 22%)	1%	
Value of the refund feature to the nearest dollar (1% of $12,000)		120
Investment in the contract adjusted for present value of the refund feature		$32, 930

(d) *Adjustment of investment in the contract where paragraph (b)(3) of § 1.72–2 applies to payments.*—(1) If paragraph (b)(3) of §1.72–2 applies to payments to be made under a contract and this section also applies because of the provision for a refund feature, an adjustment shall be made to the investment in the contract in accordance with this paragraph before making the computations required by paragraph (d)(3) of § 1.72–4 and paragraph (b)(7) of

§ 1.72–5. In the case of the guarantee of a specified amount, the adjustment shall be made by applying the appropriate multiple from Table III, as otherwise determined under this section, to the investment in the contract or the guaranteed amount, whichever is the lesser. The guarantee period shall be found by dividing the amount guaranteed by an amount determined by placing the payments received during the first taxable year (to the extent such payments reduce the guaranteed amount) on an annual basis. Thus, if monthly payments are first received by a taxpayer on a calendar year basis in August, his total payments (to the extent that they reduce the guaranteed amount) for the taxable year would be divided by 5 and multiplied by 12. The guaranteed amount would then be divided by the result of this computation to obtain the guarantee period. If the contract merely guarantees that proceeds from a unit or units of a fund shall be paid for a fixed number of years or the life (or lives) of an annuitant (or annuitants), whichever is the longer, the fixed number of years is the guarantee period. The appropriate percentage in Table III shall be applied to whichever of the following is the smaller: (i) the investment in the contract; or (ii) the product of the payments received in the first taxable year, placed on an annual basis, multiplied by the number of years for which payment of the proceeds of a unit or units is guaranteed.

(2) The principles of this paragraph may be illustrated by the following example:

Example. Taxpayer A, a 50-year old male, purchases for $25,000, a contract which provides for variable monthly payments to be paid to him for his life. The contract also provides that if he should die before receiving payments for fifteen years, payments shall continue according to the original formula to his estate or beneficiary until payments have been made for that period. Beginning with the month of September, A receives payments which total $450 for the first taxable year of receipt. This amount, placed on an annual basis, is $1,350 ($450 divided by 4, or $112.50; $112.50 multiplied by 12, or $1,350). The guaranteed amount is considered to be $20,250 ($1,350×15), and the multiple from Table III (found in the same manner as in paragraph (b) of this section), 9 percent, applied to $20,250 (since this amount is less than the investment in the contract), results in a refund adjustment of $1,822.50. The latter amount, subtracted from the investment in the contract of $25,000, results in an adjusted investment in the contract of $23,177.50. If A dies before receiving payments for 15 years and the remaining payments are made to B, his beneficiary, B shall exclude the entire amount of such payments from his gross income until the amounts so received by B, together with the amounts received by A and excludable from A's gross income, equal or exceed $25,000. Any excess and any payments thereafter received by B shall be fully includible in gross income.

(e) *Adjustment of the investment in the contract where more than one annuity element is provided for a single consideration.*—In the

case of contracts to which paragraph (b) of § 1.72–6 applies for the purpose of allocating the investment in the contract to two or more annuity elements which are provided for a single consideration, if one or more of such elements involves a refund feature, the portion of the investment in the contract properly allocable to each such element shall be adjusted for the refund feature before aggregating all the investments in order to obtain the exclusion ratio which is to apply to the contract as a whole. For example, if Taxpayer A, an insured 70 years of age, upon maturity of an endowment policy which cost him a net amount of $86,000, elected a dual settlement consisting of (1) monthly payments for his life aggregating $4,146 per year with 10 years' payments certain, and (2) monthly payments for his 60-year old brother, B, aggregating $2,820 per year with 20 years' payments certain, the exclusion ratio to be used by both A and B would be determined in the following manner:

A's expected return (A's payments per year of $4,146 multiplied by his life expectancy from Table I of 12.1)	$50,166.60	
B's expected return (B's payments per year of $2,820 multiplied by his life expectancy from Table I of 18.2)	51,324.00	
Sum of expected returns to be used in determining exclusion ratio		$101,490.60
Percentage of total expected return attributable to A's expectancy of life ($50,166.60÷$101,490.60)	49.4%	
Percentage of total expected return attributable to B's expectancy of life ($51,324÷$101,490.60)	50.6%	
Portion of investment in the contract allocable to A's annuity (49.4% of $86,000)	$42,484.00	
Portion of investment in the contract allocable to B's annuity (50.6% of $86,000)	$43,516.00	
Value of the refund feature with respect to A's annuity (percentage from Table III for male, age 70, and duration 10, or 21%, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $41,460)	$8,707.00	
A's allocable portion of the investment in the contract adjusted for refund feature ($42,484 less $8,707.00)		$33,777.00
Value of the refund feature with respect to B's annuity (percentage from Table III for male, age 60, and duration 20, or 25%, multiplied by lesser of guaranteed amount and allocable portion of investment in the contract, $43,516)	$10,879.00	
B's allocable portion of the investment in the contract adjusted for refund feature ($43,516 less $10,879.00)		32,637.00
Sum of A's and B's allocable portions of the investment in the contract after adjustment for the refund feature		$66,414.00
Exclusion ratio for the contract as a whole (total adjusted investment in the contract, $66,414, divided by the total expected return from above, $101,490.60)		65.4%

§ 1.72–8 Effect of Certain Employer Contributions With Respect to Premiums or Other Consideration Paid or Contributed by an Employee.—(a) *Contributions in the nature of compensation.*—(1) Section 72(f) provides that, for the purposes of section 72(c), (d), and (e), amounts contributed by an employer for the benefit of an employee or his beneficiaries shall constitute consideration paid or contributed by the employee to the extent that—

(i) Such amounts were includible in the gross income of the employee under this subtitle or prior income tax laws, or

(ii) Such amounts would not have been includible in the gross income of the employee at the time contributed had they been paid directly to the employee at that time.

Amounts to which subdivision (i) of this subparagraph applies include, for example, contributions made by an employer to or under a trust or plan which fails to qualify under the provisions of section 401(a), provided that the employee's rights to such contributions or under the plan are nonforfeitable at the time the contributions are made. See sections 402(b) and 403(b) and the regulations thereunder. This subdivision also applies to premiums paid by an employer for life insurance protection for an employee if such premiums are includible in the gross income of the employee when paid. See paragraph (d) of § 1.403(a)–1. However, such premiums shall only be considered as premiums and other consideration paid by the employee with respect to any benefits attributable to the contract providing the life insurance protection. See paragraph (a)(3)(i) of § 1.402(a)–1. Amounts to which subdivision (ii) applies include, for example, contributions made by an employer after December 31, 1950, if made on account of foreign services rendered by an employee during a period in which the employee qualified as a bona fide resident of a foreign country under section 911(a) or under section 116(a) of the Internal Revenue Code of 1939. In such a case, it would be immaterial whether such contributions were made under a qualified plan or otherwise. On the other hand, if contributions are made by an employer to a qualified plan at a time when compensation paid directly to the employee concerned with respect to the same services rendered would have been includible in the gross income of the employee, such as in the case of an employee of a State government where contributions are made in 1955 with respect to services rendered by the employee prior to the year 1939, subdivision (ii) does not apply to such contributions. If contributions made by an employer are made with respect to both foreign service and domestic service of the employee, subdivision (ii) shall apply only to the portion of the contributions of the employer which bears the same ratio to the total employer contributions as the total other compensation of the employee attributable to his foreign service bears to the total other compensation paid to the employee for both his foreign and domestic services and shall in no event exceed the amount which would have been excludable if paid directly to the employee as compensation.

(2) Amounts contributed by an employer which were not includible in the gross income of the employee under this subtitle or prior income tax laws, but which would have been includible therein had they been paid directly to the employee, do not constitute consideration paid or contributed by the employee for the purposes of section 72. For example, contributions made by an employer under a qualified employees' trust or plan, which contributions would have been includible in the gross income of the employee had such contributions been paid to him directly as compensation, do not constitute consideration paid or contributed by the employee. Accordingly, the aggregate amount of premiums or other consideration paid or contributed by an employee, insofar as compensatory employer contributions are concerned, consists solely of the (i) sum of all amounts actually contributed by the employee, plus (ii) contributions in the nature of compensation which are deemed to be paid or contributed by the employee under subparagraph (1) of this paragraph.

(b) *Contributions in the nature of death benefits.*—In the case of an employee's beneficiary, the aggregate amount of premiums or other consideration paid or deemed to be paid or contributed by the employee shall also include—

(1) Amounts (other than amounts paid as an annuity) to the extent such amounts are excludable from the beneficiary's gross income as a death benefit under section 101(b), and

(2) Any amount or amounts of death benefits which are treated as additional consideration contributed by the employee under section 101(b)(2)(D) and the regulations thereunder, or which were excludable from the beneficiary's gross income as a death benefit under section 22 (b)(1)(B) of the Internal Revenue Code of 1939 and the regulations thereunder.

Accordingly, in the case of an employee's beneficiary, any such amount shall be added to any amount or amounts deemed paid or contributed by the employee under paragraph (a)(1) of this section and to any amounts actually contributed by the employee for the purpose of finding the aggregate amount of premiums or other consideration paid or contributed by the employee.

(c) *Amounts "made available" to an employee or his beneficiary.*— Any amount which, although not actually paid, is made available to and includible in the gross income of an employee or his beneficiary under the rules of sections 402 and 403 and the regulations thereunder, shall be considered an amount contributed by the employee and shall be aggregated with amounts, if any, to which paragraphs (a) and (b) of this section apply for the purpose of determining the aggregate amount of premiums or other consideration paid by the employee.

§ 1.72–9 TABLES.—The following tables are to be used in connection with computations under section 72 and the regulations thereunder:

Table I.—Ordinary Life Annuities—One Life—Expected Return Multiples

Ages: Male	Ages: Female	Multiples	Ages: Male	Ages: Female	Multiples	Ages: Male	Ages: Female	Multiples
6	11	65.0	41	46	33.0	76	81	9.1
7	12	64.1	42	47	32.1	77	82	8.7
8	13	63.2	43	48	31.2	78	83	8.3
9	14	62.3	44	49	30.4	79	84	7.8
10	15	61.4	45	50	29.6	80	85	7.5
11	16	60.4	46	51	28.7	81	86	7.1
12	17	59.5	47	52	27.9	82	87	6.7
13	18	58.6	48	53	27.1	83	88	6.3
14	19	57.7	49	54	26.3	84	89	6.0
15	20	56.7	50	55	25.5	85	90	5.7
16	21	55.8	51	56	24.7	86	91	5.4
17	22	54.9	52	57	24.0	87	92	5.1
18	23	53.9	53	58	23.2	88	93	4.8
19	24	53.0	54	59	22.4	89	94	4.5
20	25	52.1	55	60	21.7	90	95	4.2
21	26	51.1	56	61	21.0	91	96	4.0
22	27	50.2	57	62	20.3	92	97	3.7
23	28	49.3	58	63	19.6	93	98	3.5
24	29	48.3	59	64	18.9	94	99	3.3
25	30	47.4	60	65	18.2	95	100	3.1
26	31	46.5	61	66	17.5	96	101	2.9
27	32	45.6	62	67	16.9	97	102	2.7
28	33	44.6	63	68	16.2	98	103	2.5
29	34	43.7	64	69	15.6	99	104	2.3
30	35	42.8	65	70	15.0	100	105	2.1
31	36	41.9	66	71	14.4	101	106	1.9
32	37	41.0	67	72	13.8	102	107	1.7
33	38	40.0	68	73	13.2	103	108	1.5
34	39	39.1	69	74	12.6	104	109	1.3
35	40	38.2	70	75	12.1	105	110	1.2
36	41	37.3	71	76	11.6	106	111	1.0
37	42	36.5	72	77	11.0	107	112	.8
38	43	35.6	73	78	10.5	108	113	.7
39	44	34.7	74	79	10.1	109	114	.6
40	45	33.8	75	80	9.6	110	115	.5
						111	116	0

Table II.—Ordinary Joint Life and Last Survivor Annuities—Two Lives—Expected Return Multiples

Ages	Male	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Male	Female	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25
6	11	73.5	73.0	72.6	72.2	71.8	71.4	71.0	70.7	70.4	70.0	69.7	69.5	69.2	68.9	68.7
7	12	73.0	72.6	72.1	71.7	71.3	70.9	70.5	70.1	69.8	69.4	69.1	68.8	68.5	68.3	68.0
8	13	72.6	72.1	71.6	71.2	70.8	70.4	70.0	69.6	69.2	68.9	68.5	68.2	67.9	67.6	67.3
9	14	72.2	71.7	71.2	70.7	70.3	69.9	69.4	69.0	68.7	68.3	67.9	67.6	67.3	67.0	66.7
10	15	71.8	71.3	70.8	70.3	69.8	69.4	68.9	68.5	68.1	67.7	67.4	67.0	66.7	66.4	66.1
11	16	71.4	70.9	70.4	69.9	69.4	68.9	68.5	68.0	67.6	67.2	66.8	66.5	66.1	65.8	65.4
12	17	71.0	70.5	70.0	69.4	68.9	68.5	68.0	67.5	67.1	66.7	66.3	65.9	65.5	65.2	64.8
13	18	70.7	70.1	69.6	69.0	68.5	68.0	67.5	67.1	66.6	66.2	65.8	65.4	65.0	64.6	64.2
14	19	70.4	69.8	69.2	68.7	68.1	67.6	67.1	66.6	66.1	65.7	65.3	64.8	64.4	64.0	63.7
15	20	70.0	69.4	68.9	68.3	67.7	67.2	66.7	66.2	65.7	65.2	64.8	64.3	63.9	63.5	63.1
16	21	69.7	69.1	68.5	67.9	67.4	66.8	66.3	65.8	65.3	64.8	64.3	63.8	63.4	63.0	62.6
17	22	69.5	68.8	68.2	67.6	67.0	66.5	65.9	65.4	64.8	64.3	63.8	63.4	62.9	62.5	62.0
18	23	69.2	68.5	67.9	67.3	66.7	66.1	65.5	65.0	64.4	63.9	63.4	62.9	62.4	62.0	61.5
19	24	68.9	68.3	67.6	67.0	66.4	65.8	65.2	64.6	64.0	63.5	63.0	62.5	62.0	61.5	61.0
20	25	68.7	68.0	67.3	66.7	66.1	65.4	64.8	64.2	63.7	63.1	62.6	62.0	61.5	61.0	60.6

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages: Male	Ages: Female	Male 21 / Female 26	22 / 27	23 / 28	24 / 29	25 / 30	26 / 31	27 / 32	28 / 33	29 / 34	30 / 35	31 / 36	32 / 37	33 / 38	34 / 39
6	11	68.4	68.2	68.0	67.8	67.6	67.5	67.3	67.1	67.0	66.8	66.7	66.6	66.5	66.4
7	12	67.8	67.5	67.3	67.1	66.9	66.7	66.5	66.4	66.2	66.1	65.9	65.8	65.7	65.6
8	13	67.1	66.8	66.6	66.4	66.2	66.0	65.8	65.6	65.4	65.3	65.1	65.0	64.9	64.7
9	14	66.4	66.2	65.9	65.7	65.4	65.2	65.0	64.8	64.7	64.5	64.3	64.2	64.1	63.9
10	15	65.8	65.5	65.2	65.0	64.7	64.5	64.3	64.1	63.9	63.7	63.6	63.4	63.3	63.1
11	16	65.1	64.8	64.6	64.3	64.1	63.8	63.6	63.4	63.2	63.0	62.8	62.6	62.5	62.3
12	17	64.5	64.2	63.9	63.6	63.4	63.1	62.9	62.7	62.4	62.2	62.0	61.9	61.7	61.5
13	18	63.9	63.6	63.3	63.0	62.7	62.4	62.2	61.9	61.7	61.5	61.3	61.1	60.9	60.8
14	19	63.3	63.0	62.7	62.3	62.0	61.8	61.5	61.2	61.0	60.8	60.6	60.4	60.2	60.0
15	20	62.7	62.4	62.0	61.7	61.4	61.1	60.8	60.6	60.3	60.1	59.8	59.6	59.4	59.2
16	21	62.2	61.8	61.4	61.1	60.8	60.5	60.2	59.9	59.6	59.4	59.1	58.9	58.7	58.5
17	22	61.6	61.2	60.9	60.5	60.2	59.8	59.5	59.2	58.9	58.7	58.4	58.2	57.9	57.7
18	23	61.1	60.7	60.3	59.9	59.6	59.2	58.9	58.6	58.3	58.0	57.7	57.5	57.2	57.0
19	24	60.6	60.2	59.7	59.4	59.0	58.6	58.3	57.9	57.6	57.3	57.0	56.8	56.5	56.3
20	25	60.1	59.6	59.2	58.8	58.4	58.0	57.7	57.3	57.0	56.7	56.4	56.1	55.8	55.6
21	26	59.6	59.1	58.7	58.3	57.9	57.5	57.1	56.7	56.4	56.0	55.7	55.4	55.1	54.9
22	27	59.1	58.7	58.2	57.7	57.3	56.9	56.5	56.1	55.8	55.4	55.1	54.8	54.5	54.2
23	28	58.7	58.2	57.7	57.2	56.8	56.4	55.9	55.5	55.2	54.8	54.4	54.1	53.8	53.5
24	29	58.3	57.7	57.2	56.8	56.3	55.8	55.4	55.0	54.6	54.2	53.8	53.5	53.2	52.8
25	30	57.9	57.3	56.8	56.3	55.8	55.3	54.9	54.4	54.0	53.6	53.2	52.9	52.5	52.2
26	31	57.5	56.9	56.4	55.8	55.3	54.8	54.4	53.9	53.5	53.1	52.7	52.3	51.9	51.6
27	32	57.1	56.5	55.9	55.4	54.9	54.4	53.9	53.4	53.0	52.5	52.1	51.7	51.3	50.9
28	33	56.7	56.1	55.5	55.0	54.4	53.9	53.4	52.9	52.4	52.0	51.6	51.1	50.7	50.3
29	34	56.4	55.8	55.2	54.6	54.0	53.5	53.0	52.4	52.0	51.5	51.0	50.6	50.2	49.8
30	35	56.0	55.4	54.8	54.2	53.6	53.1	52.5	52.0	51.5	51.0	50.5	50.1	49.6	49.2
31	36	55.7	55.1	54.4	53.8	53.2	52.7	52.1	51.6	51.0	50.5	50.0	49.5	49.1	48.7
32	37	55.4	54.8	54.1	53.5	52.9	52.3	51.7	51.1	50.6	50.1	49.5	49.1	48.6	48.1
33	38	55.1	54.5	53.8	53.2	52.5	51.9	51.3	50.7	50.2	49.6	49.1	48.6	48.1	47.6
34	39	54.9	54.2	53.5	52.8	52.2	51.6	50.9	50.3	49.8	49.2	48.7	48.1	47.6	47.1

Ages: Male	Ages: Female	Male 35 / Female 40	36 / 41	37 / 42	38 / 43	39 / 44	40 / 45	41 / 46	42 / 47	43 / 48	44 / 49	45 / 50	46 / 51	47 / 52	48 / 53	49 / 54
6	11	66.3	66.2	66.1	66.0	65.9	65.9	65.8	65.7	65.7	65.6	65.6	65.5	65.5	65.5	65.4
7	12	65.4	65.3	65.3	65.2	65.1	65.0	64.9	64.9	64.8	64.8	64.7	64.7	64.6	64.6	64.5
8	13	64.6	64.5	64.4	64.3	64.2	64.2	64.1	64.0	64.0	63.9	63.8	63.8	63.7	63.7	63.7
9	14	63.8	63.7	63.6	63.5	63.4	63.3	63.2	63.2	63.1	63.0	63.0	62.9	62.9	62.8	62.8
10	15	63.0	62.9	62.8	62.7	62.6	62.5	62.4	62.3	62.2	62.2	62.1	62.0	62.0	61.9	61.9
11	16	62.2	62.1	61.9	61.8	61.7	61.6	61.5	61.4	61.4	61.3	61.2	61.2	61.1	61.0	61.0
12	17	61.4	61.3	61.1	61.0	60.9	60.8	60.7	60.6	60.5	60.4	60.4	60.3	60.2	60.2	60.1
13	18	60.6	60.5	60.3	60.2	60.1	60.0	59.9	59.8	59.7	59.6	59.5	59.4	59.4	59.3	59.2
14	19	59.8	59.7	59.5	59.4	59.3	59.1	59.0	58.9	58.8	58.7	58.6	58.6	58.5	58.4	58.4
15	20	59.0	58.9	58.7	58.6	58.4	58.3	58.2	58.1	58.0	57.9	57.8	57.7	57.6	57.6	57.5
16	21	58.3	58.1	57.9	57.8	57.6	57.5	57.4	57.2	57.1	57.0	56.9	56.8	56.8	56.7	56.6
17	22	57.5	57.3	57.2	57.0	56.8	56.7	56.6	56.4	56.3	56.2	56.1	56.0	55.9	55.8	55.7
18	23	56.8	56.6	56.4	56.2	56.0	55.9	55.7	55.6	55.5	55.4	55.2	55.1	55.1	55.0	54.9
19	24	56.0	55.8	55.6	55.4	55.3	55.1	54.9	54.8	54.7	54.5	54.4	54.3	54.2	54.1	54.0
20	25	55.3	55.1	54.9	54.7	54.5	54.3	54.1	54.0	53.8	53.7	53.6	53.5	53.4	53.3	53.2
21	26	54.6	54.4	54.1	53.9	53.7	53.5	53.4	53.2	53.0	52.9	52.8	52.6	52.5	52.4	52.3
22	27	53.9	53.6	53.4	53.2	53.0	52.8	52.6	52.4	52.2	52.1	51.9	51.8	51.7	51.6	51.5
23	28	53.2	52.9	52.7	52.5	52.2	52.0	51.8	51.6	51.5	51.3	51.1	51.0	50.9	50.7	50.6
24	29	52.5	52.3	52.0	51.7	51.5	51.3	51.1	50.9	50.7	50.5	50.3	50.2	50.0	49.9	49.8
25	30	51.9	51.6	51.3	51.0	50.8	50.5	50.3	50.1	49.9	49.7	49.6	49.4	49.2	49.1	49.0
26	31	51.2	50.9	50.6	50.3	50.1	49.8	49.6	49.4	49.2	49.0	48.8	48.6	48.4	48.3	48.1
27	32	50.6	50.3	50.0	49.7	49.4	49.1	48.9	48.6	48.4	48.2	48.0	47.8	47.6	47.5	47.3
28	33	50.0	49.6	49.3	49.0	48.7	48.4	48.2	47.9	47.7	47.5	47.2	47.1	46.9	46.7	46.5
29	34	49.4	49.0	48.7	48.3	48.0	47.7	47.5	47.2	47.0	46.7	46.5	46.3	46.1	45.9	45.7
30	35	48.8	48.4	48.1	47.7	47.4	47.1	46.8	46.5	46.2	46.0	45.8	45.5	45.3	45.2	45.0
31	36	48.2	47.8	47.5	47.1	46.8	46.4	46.1	45.8	45.6	45.3	45.0	44.8	44.6	44.4	44.2
32	37	47.7	47.3	46.9	46.5	46.1	45.8	45.5	45.2	44.9	44.6	44.3	44.1	43.9	43.7	43.4
33	38	47.2	46.7	46.3	45.9	45.5	45.2	44.8	44.5	44.2	43.9	43.7	43.4	43.2	42.9	42.7
34	39	46.7	46.2	45.8	45.4	45.0	44.6	44.2	43.9	43.6	43.3	43.0	42.7	42.5	42.2	42.0

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages															
	Male	50	51	52	53	54	55	56	57	58	59	60	61	62	63
Male	Female	55	56	57	58	59	60	61	62	63	64	65	66	67	68
6	11	65.4	65.4	65.3	65.3	65.3	65.3	65.3	65.2	65.2	65.2	65.2	65.2	65.2	65.2
7	12	64.5	64.5	64.4	64.4	64.4	64.4	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.2
8	13	63.6	63.6	63.5	63.5	63.5	63.5	63.4	63.4	63.4	63.4	63.4	63.4	63.3	63.3
9	14	62.7	62.7	62.7	62.6	62.6	62.6	62.5	62.5	62.5	62.5	62.5	62.4	62.4	62.4
10	15	61.8	61.8	61.8	61.7	61.7	61.7	61.6	61.6	61.6	61.6	61.6	61.5	61.5	61.5
11	16	61.0	60.9	60.9	60.8	60.8	60.8	60.7	60.7	60.7	60.7	60.6	60.6	60.6	60.6
12	17	60.1	60.0	60.0	59.9	59.9	59.9	59.8	59.8	59.8	59.8	59.7	59.7	59.7	59.7
13	18	59.2	59.1	59.1	59.0	59.0	59.0	58.9	58.9	58.9	58.9	58.8	58.8	58.8	58.8
14	19	58.3	58.2	58.2	58.2	58.1	58.1	58.0	58.0	58.0	57.9	57.9	57.9	57.9	57.9
15	20	57.4	57.4	57.3	57.3	57.2	57.2	57.1	57.1	57.1	57.0	57.0	57.0	57.0	56.9
16	21	56.5	56.5	56.4	56.4	56.3	56.3	56.2	56.2	56.2	56.1	56.1	56.1	56.1	56.0
17	22	55.7	55.6	55.5	55.5	55.4	55.4	55.3	55.3	55.3	55.2	55.2	55.2	55.1	55.1
18	23	54.8	54.7	54.7	54.6	54.6	54.5	54.5	54.4	54.4	54.3	54.3	54.3	54.2	54.2
19	24	53.9	53.9	53.8	53.7	53.7	53.6	53.6	53.5	53.5	53.4	53.4	53.4	53.3	53.3
20	25	53.1	53.0	52.9	52.8	52.8	52.7	52.7	52.6	52.6	52.5	52.5	52.4	52.4	52.4
21	26	52.2	52.1	52.0	52.0	51.9	51.8	51.8	51.7	51.7	51.6	51.6	51.5	51.5	51.5
22	27	51.4	51.3	51.2	51.1	51.0	51.0	50.9	50.8	50.8	50.7	50.7	50.6	50.6	50.6
23	28	50.5	50.4	50.3	50.2	50.2	50.1	50.0	50.0	49.9	49.8	49.8	49.7	49.7	49.7
24	29	49.7	49.6	49.5	49.4	49.3	49.2	49.1	49.1	49.0	49.0	48.9	48.9	48.8	48.8
25	30	48.8	48.7	48.6	48.5	48.4	48.3	48.3	48.2	48.1	48.1	48.0	48.0	47.9	47.9
26	31	48.0	47.9	47.8	47.7	47.6	47.5	47.4	47.3	47.3	47.2	47.1	47.1	47.0	47.0
27	32	47.2	47.1	46.9	46.8	46.7	46.6	46.5	46.5	46.4	46.3	46.2	46.2	46.1	46.1
28	33	46.4	46.3	46.1	46.0	45.9	45.8	45.7	45.6	45.5	45.4	45.4	45.3	45.2	45.2
29	34	45.6	45.4	45.3	45.2	45.1	44.9	44.8	44.7	44.7	44.6	44.5	44.4	44.4	44.3
30	35	44.8	44.6	44.5	44.4	44.2	44.1	44.0	43.9	43.8	43.7	43.6	43.6	43.5	43.4
31	36	44.0	43.9	43.7	43.6	43.4	43.3	43.2	43.1	43.0	42.9	42.8	42.7	42.6	42.6
32	37	43.3	43.1	42.9	42.8	42.6	42.5	42.4	42.2	42.1	42.0	41.9	41.9	41.8	41.7
33	38	42.5	42.3	42.1	42.0	41.8	41.7	41.5	41.4	41.3	41.2	41.1	41.0	40.9	40.8
34	39	41.8	41.6	41.4	41.2	41.0	40.9	40.7	40.6	40.5	40.4	40.3	40.2	40.1	40.0

Ages																
	Male	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
Male	Female	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1
7	12	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.2	64.1	64.1
8	13	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.3	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.4	62.4	62.4	62.4	62.4	62.4	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.5	61.5	61.5	61.5	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.6	60.6	60.6	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5
12	17	59.7	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.6	59.5	59.5
13	18	58.8	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.7	58.6	58.6	58.6	58.6	58.6
14	19	57.8	57.8	57.8	57.8	57.8	57.8	57.8	57.7	57.7	57.7	57.7	57 7	57.7	57.7	57.7
15	20	56.9	56.9	56.9	56.9	56.9	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8	56.8
16	21	56.0	56.0	56.0	56.0	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.9	55.8
17	22	55.1	55.1	55.1	55.0	55.0	55.0	55.0	55.0	55.0	55.0	55.0	54.9	54.9	54.9	54.9
18	23	54.2	54.2	54.1	54.1	54.1	54.1	54.1	54.1	54.0	54.0	54.0	54.0	54.0	54.0	54.0
19	24	53.3	53.2	53.2	53.2	53.2	53.2	53.2	53.1	53.1	53.1	53.1	53.1	53.1	53.1	53.1
20	25	52.4	52.3	52.3	52.3	52.3	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.2	52.1	52.1
21	26	51.4	51.4	51.4	51.4	51.3	51.3	51.3	51.3	51.3	51.3	51.3	51.2	51.2	51.2	51.2
22	27	50.5	50.5	50.5	50.5	50.4	50.4	50.4	50.4	50.4	50.3	50.3	50.3	50.3	50.3	50.3
23	28	49.6	49.6	49.6	49.5	49.5	49.5	49.5	49.5	49.4	49.4	49.4	49.4	49.4	49.4	49.4
24	29	48.7	48.7	48.7	48.6	48.6	48.6	48.6	48.5	48.5	48.5	48.5	48.5	48.5	48.4	48.4
25	30	47.8	47.8	47.8	47.7	47.7	47.7	47.6	47.6	47.6	47.6	47.6	47.5	47.5	47.5	47.5
26	31	46.9	46.9	46.8	46.8	46.8	46.8	46.7	46.7	46.7	46.7	46.6	46.6	46.6	46.6	46.6
27	32	46.0	46.0	45.9	45.9	45.9	45.8	45.8	45.8	45.8	45.7	45.7	45.7	45.7	45.7	45.7
28	33	45.1	45.1	45.1	45.0	45.0	44.9	44.9	44.9	44.9	44.8	44.8	44.8	44.8	44.8	44.8
29	34	44.3	44.2	44.2	44.1	44.1	44.0	44.0	44.0	44.0	43.9	43.9	43.9	43.9	43.9	43.8
30	35	43.4	43.3	43.3	43.2	43.2	43.1	43.1	43.1	43.1	43.0	43.0	43.0	43.0	42.9	42.9
31	36	42.5	42.4	42.4	42.3	42.3	42.3	42.2	42.2	42.2	42.1	42.1	42.1	42.1	42.0	42.0
32	37	41.6	41.6	41.5	41.5	41.4	41.4	41.3	41.3	41.3	41.2	41.2	41.2	41.2	41.1	41.1
33	38	40.8	40.7	40.7	40.6	40.5	40.5	40.5	40.4	40.4	40.3	40.3	40.3	40.3	40.2	40.2
34	39	39.9	39.9	39.8	39.7	39.7	39.6	39.6	39.5	39.5	39.5	39.4	39.4	39.4	39.3	39.3

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages Male	Ages Female	79 / 84	80 / 85	81 / 86	82 / 87	83 / 88	84 / 89	85 / 90	86 / 91	87 / 92	88 / 93	89 / 94	90 / 95	91 / 96	92 / 97
6	11	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.1	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.5	60.5	60.5	60.5	60.5	60.5	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.8	56.8	56.8	56.8	56.8	56.8	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	54.0	53.9
19	24	53.1	53.1	53.1	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2	51.2
22	27	50.3	50.3	50.3	50.3	50.3	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.4	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4
25	30	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.5	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.6	46.6	46.6	46.6	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.7	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7
29	34	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.8	43.7*	43.7	43.7	43.7	43.7
30	35	42.9	42.9	42.9	42.9	42.9	42.9	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	42.0	42.0	42.0	42.0	42.0	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.1	41.1	41.1	41.1	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.2	40.2	40.2	40.2	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1
34	39	39.3	39.3	39.3	39.3	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2

Ages Male	Ages Female	93 / 98	94 / 99	95 / 100	96 / 101	97 / 102	98 / 103	99 / 104	100 / 105	101 / 106	102 / 107	103 / 108	104 / 109	105 / 110	106 / 111	107 / 112	108 / 113
6	11	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0	65.0
7	12	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1	64.1
8	13	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2	63.2
9	14	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3	62.3
10	15	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4	61.4
11	16	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4	60.4
12	17	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
13	18	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6	58.6
14	19	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7	57.7
15	20	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7	56.7
16	21	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8	55.8
17	22	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9	54.9
18	23	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9	53.9
19	24	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0	53.0
20	25	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1	52.1
21	26	51.2	51.2	51.2	51.2	51.2	51.2	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1	51.1
22	27	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2	50.2
23	28	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3	49.3
24	29	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.4	48.3	48.3
25	30	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4	47.4
26	31	46.5	46.5†	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5	46.5
27	32	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6	45.6
28	33	44.7	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6	44.6
29	34	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7	43.7
30	35	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8	42.8
31	36	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9	41.9
32	37	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0	41.0
33	38	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.1	40.0
34	39	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.2	39.1	39.1	39.1	39.1	39.1

*Erroneously shown as 43.8 in T. D. 6211; corrected by T. D. 6233.
†Erroneously shown as 56.5 in T. D. 6211; corrected by T. D. 6233.

§ 1.72–9

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages Male	Ages Female	35 / 40	36 / 41	37 / 42	38 / 43	39 / 44	40 / 45	41 / 46	42 / 47	43 / 48	44 / 49	45 / 50	46 / 51	47 / 52
35	40	46.2	45.7	45.3	44.8	44.4	44.0	43.6	43.3	43.0	42.6	42.3	42.0	41.8
36	41	45.7	45.2	44.8	44.3	43.9	43.5	43.1	42.7	42.3	42.0	41.7	41.4	41.1
37	42	45.3	44.8	44.3	43.8	43.4	42.9	42.5	42.1	41.8	41.4	41.1	40.7	40.4
38	43	44.8	44.3	43.8	43.3	42.9	42.4	42.0	41.6	41.2	40.8	40.5	40.1	39.8
39	44	44.4	43.9	43.4	42.9	42.4	41.9	41.5	41.0	40.6	40.2	39.9	39.5	39.2
40	45	44.0	43.5	42.9	42.4	41.9	41.4	41.0	40.5	40.1	39.7	39.3	38.9	38.6
41	46	43.6	43.1	42.5	42.0	41.5	41.0	40.5	40.0	39.6	39.2	38.8	38.4	38.0
42	47	43.3	42.7	42.1	41.6	41.0	40.5	40.0	39.6	39.1	38.7	38.2	37.8	37.5
43	48	43.0	42.3	41.8	41.2	40.6	40.1	39.6	39.1	38.6	38.2	37.7	37.3	36.9
44	49	42.6	42.0	41.4	40.8	40.2	39.7	39.2	38.7	38.2	37.7	37.2	36.8	36.4
45	50	42.3	41.7	41.1	40.5	39.9	39.3	38.8	38.2	37.7	37.2	36.8	36.3	35.9
46	51	42.0	41.4	40.7	40.1	39.5	38.9	38.4	37.8	37.3	36.8	36.3	35.9	35.4
47	52	41.8	41.1	40.4	39.8	39.2	38.6	38.0	37.5	36.9	36.4	35.9	35.4	35.0

Ages Male	Ages Female	48 / 53	49 / 54	50 / 55	51 / 56	52 / 57	53 / 58	54 / 59	55 / 60	56 / 61	57 / 62	58 / 63	59 / 64	60 / 65
35	40	41.5	41.3	41.0	40.8	40.6	40.4	40.3	40.1	40.0	39.8	39.7	39.6	39.5
36	41	40.8	40.6	40.3	40.1	39.9	39.7	39.5	39.3	39.2	39.0	38.9	38.8	38.6
37	42	40.2	39.9	39.6	39.4	39.2	39.0	38.8	38.6	38.4	38.3	38.1	38.0	37.9
38	43	39.5	39.2	39.0	38.7	38.5	38.3	38.1	37.9	37.7	37.5	37.3	37.2	37.1
39	44	38.9	38.6	38.3	38.0	37.8	37.6	37.3	37.1	36.9	36.8	36.6	36.4	36.3
40	45	38.3	38.0	37.7	37.4	37.1	36.9	36.6	36.4	36.2	36.0	35.9	35.7	35.5
41	46	37.7	37.3	37.0	36.7	36.5	36.2	36.0	35.7	35.5	35.3	35.1	35.0	34.8
42	47	37.1	36.8	36.4	36.1	35.8	35.6	35.3	35.1	34.8	34.6	34.4	34.2	34.1
43	48	36.5	36.2	35.8	35.5	35.2	34.9	34.7	34.4	34.2	33.9	33.7	33.5	33.3
44	49	36.0	35.6	35.3	34.9	34.6	34.3	34.0	33.8	33.5	33.3	33.0	32.8	32.6
45	50	35.5	35.1	34.7	34.4	34.0	33.7	33.4	33.1	32.9	32.6	32.4	32.2	31.9
46	51	35.0	34.6	34.2	33.8	33.5	33.1	32.8	32.5	32.2	32.0	31.7	31.5	31.3
47	52	34.5	34.1	33.7	33.3	32.9	32.6	32.2	31.9	31.6	31.4	31.1	30.9	30.6
48	53	34.0	33.6	33.2	32.8	32.4	32.0	31.7	31.4	31.1	30.8	30.5	30.2	30.0
49	54	33.6	33.1	32.7	32.3	31.9	31.5	31.2	30.8	30.5	30.2	29.9	29.6	29.4
50	55	33.2	32.7	32.3	31.8	31.4	31.0	30.6	30.3	29.9	29.6	29.3	29.0	28.8
51	56	32.8	32.3	31.8	31.4	30.9	30.5	30.1	29.8	29.4	29.1	28.8	28.5	28.2
52	57	32.4	31.9	31.4	30.9	30.5	30.1	29.7	29.3	28.9	28.6	28.2	27.9	27.6
53	58	32.0	31.5	31.0	30.5	30.1	29.6	29.2	28.8	28.4	28.1	27.7	27.4	27.1
54	59	31.7	31.2	30.6	30.1	29.7	29.2	28.8	28.3	27.9	27.6	27.2	26.9	26.5
55	60	31.4	30.8	30.3	29.8	29.3	28.8	28.3	27.9	27.5	27.1	26.7	26.4	26.0
56	61	31.1	30.5	29.9	29.4	28.9	28.4	27.9	27.5	27.1	26.7	26.3	25.9	25.5
57	62	30.8	30.2	29.6	29.1	28.6	28.1	27.6	27.1	26.7	26.2	25.8	25.4	25.1
58	63	30.5	29.9	29.3	28.8	28.2	27.7	27.2	26.7	26.3	25.8	25.4	25.0	24.6
59	64	30.2	29.6	29.0	28.5	27.9	27.4	26.9	26.4	25.9	25.4	25.0	24.6	24.2
60	65	30.0	29.4	28.8	28.2	27.6	27.1	26.5	26.0	25.5	25.1	24.6	24.2	23.8

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages													
	Male	86	87	88	89	90	91	92	93	94	95	96	97
Male	Female	91	92	93	94	95	96	97	98	99	100	101	102
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3	38.3
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37 4	37.4	37.4	37.4
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5
38	43	35.7	35.7	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6
39	44	34.8	34.8	34.8	34.8	34.8	34.8	34.7	34.7	34.7	34.7	34.7	34.7
40	45	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9	33.9
41	46	33.1	33.1	33.1	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
42	47	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.2	32.1	32.1	32.1
43	48	31.4	31.4	31.4	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3
44	49	30.6	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.5	30.4
45	50	29.7	29.7	29.7	29.7	29.7	29.7	29.7	29.6	29.6	29.6	29.6	29.6
46	51	28.9	28.9	28.9	28.9	28.9	28.8	28.8	28.8	28.8	28.8	28.8	28.8
47	52	28.1	28.1	28.1	28.1	28.0	28.0	28.0	28.0	28.0	28.0	28.0	28.0
48	53	27.3	27.3	27.3	27.3	27.2	27.2	27.2	27.2	27.2	27.2	27.2	27.2
49	54	26.5	26.5	26.5	26.5	26.5	26.4	26.4	26.4	26.4	26.4	26.4	26.4
50	55	25.8	25.7	25.7	25.7	25.7	25.7	25.6	25.6	25.6	25.6	25.6	25.6
51	56	25.0	25.0	24.9	24.9	24.9	24.9	24.9	24.9	24.8	24.8	24.8	24.8
52	57	24.3	24.2	24.2	24.2	24.1	24.1	24.1	24.1	24.1	24.1	24.1	24.0
53	58	23.5	23.5	23.4	23.4	23.4	23.4	23.4	23.3	23.3	23.3	23.3	23.3
54	59	22.8	22.7	22.7	22.7	22.7	22.6	22.6	22.6	22.6	22.6	22.6	22.5
55	60	22.1	22.0	22.0	22.0	21.9	21.9	21.9	21.9	21.8	21.8	21.8	21.8
56	61	21.4	21.3	21.3	21.3	21.2	21.2	21.2	21.1	21.1	21.1	21.1	21.1
57	62	20.7	20.6	20.6	20.6	20.5	20.5	20.5	20.4	20.4	20.4	20.4	20.4
58	63	20.0	19.9	19.9	19.9	19.8	19.8	19.8	19.8	19.7	19.7	19.7	19.7
59	64	19.3	19.3	19.2	19.2	19.2	19.1	19.1	19.1	19.0	19.0	19.0	19.0

Ages												
	Male	98	99	100	101	102	103	104	105	106	107	108
Male	Female	103	104	105	106	107	108	109	110	111	112	113
35	40	38.3	38.3	38.3	38.3	38.3	38.3	38.2	38.2	38.2	38.2	38.2
36	41	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.4	37.3
37	42	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5	36.5
38	43	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6	35.6
39	44	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7
40	45	33.9	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8	33.8
41	46	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0	33.0
42	47	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1	32.1
43	48	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3	31.3
44	49	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4	30.4
45	50	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6
46	51	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.8	28.7
47	52	28.0	28.0	28.0	28.0	28.0	28.0	28.0	27.9	27.9	27.9	27.9
48	53	27.2	27.2	27.2	27.2	27.2	27.1	27.1	27.1	27.1	27.1	27.1
49	54	26.4	26.4	26.4	26.4	26.4	26.3	26.3	26.3	26.3	26.3	26.3
50	55	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.6	25.5	25.5	25.5
51	56	24 8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.8	24.7
52	57	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0	24.0
53	58	23.3	23.3	23.3	23.3	23.3	23.3	23.2	23.2	23.2	23.2	23.2
54	59	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5	22.5
55	60	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.8	21.7	21.7
56	61	21.1	21.1	21.1	21.1	21.1	21.0	21.0	21.0	21.0	21.0	21.0
57	62	20.4	20.4	20.4	20.3	20.3	20.3	20.3	20.3	20.3	20.3	20.3
58	63	19.7	19.7	19.7	19.6	19.6	19.6	19.6	19.6	19.6	19.6	19.6
59	64	19.0	19.0	19.0	19.0	19.0	18.9	18.9	18.9	18.9	18.9	18.9

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages													
	Male	86	87	88	89	90	91	92	93	94	95	96	97
Male	Female	91	92	93	94	95	96	97	98	99	100	101	102
60	65	18.7	18.6	18.6	18.5	18.5	18.5	18.4	18.4	18.4	18.4	18.3	18.3
61	66	18.1	18.0	17.9	17.9	17.9	17.8	17.8	17.8	17.7	17.7	17.7	17.7
62	67	17.4	17.4	17.3	17.3	17.2	17.2	17.1	17.1	17.1	17.1	17.0	17.0
63	68	16.8	16.8	16.7	16.7	16.6	16.6	16.5	16.5	16.5	16.4	16.4	16.4
64	69	16.2	16.2	16.1	16.1	16.0	16.0	15.9	15.9	15.9	15.8	15.8	15.8
65	70	15.7	15.6	15.5	15.5	15.4	15.4	15.3	15.3	15.3	15.2	15.2	15.2
66	71	15.1	15.0	15.0	14.9	14.8	14.8	14.7	14.7	14.7	14.6	14.6	14.6
67	72	14.6	14.5	14.4	14.4	14.3	14.2	14.2	14.1	14.1	14.1	14.1	14.0
68	73	14.1	14.0	13.9	13.8	13.8	13.7	13.6	13.6	13.6	13.5	13.5	13.5
69	74	13.6	13.5	13.4	13.3	13.2	13.2	13.1	13.1	13.0	13.0	13.0	12.9
70	75	13.1	13.0	12.9	12.8	12.7	12.7	12.6	12.5	12.5	12.5	12.4	12.4
71	76	12.6	12.5	12.4	12.3	12.2	12.2	12.1	12.1	12.0	12.0	11.9	11.9
72	77	12.1	12.0	11.9	11.8	11.8	11.7	11.6	11.6	11.5	11.5	11.4	11.4
73	78	11.7	11.6	11.5	11.4	11.3	11.2	11.2	11.1	11.0	11.0	11.0	10.9
74	79	11.3	11.2	11.1	11.0	10.9	10.8	10.7	10.7	10.6	10.6	10.5	10.5
75	80	10.9	10.8	10.7	10.5	10.5	10.4	10.3	10.2	10.2	10.1	10.1	10.0
76	81	10.5	10.4	10.3	10.2	10.1	10.0	9.9	9.8	9.7	9.7	9.7	9.6
77	82	10.2	10.0	9.9	9.8	9.7	9.6	9.5	9.4	9.3	9.3	9.2	9.2
78	83	9.8	9.7	9.5	9.4	9.3	9.2	9.1	9.0	9.0	8.9	8.9	8.8
79	84	9.5	9.3	9.2	9.1	8.9	8.8	8.8	8.7	8.6	8.5	8.5	8.4
80	85	9.2	9.0	8.9	8.7	8.6	8.5	8.4	8.3	8.3	8.2	8.1	8.1
81	86	8.9	8.7	8.6	8.4	8.3	8.2	8.1	8.0	7.9	7.9	7.8	7.7
82	87	8.6	8.4	8.3	8.1	8.0	7.9	7.8	7.7	7.6	7.5	7.5	7.4
83	88	8.3	8.2	8.0	7.9	7.7	7.6	7.5	7.4	7.3	7.2	7.2	7.1
84	89	8.1	7.9	7.8	7.6	7.5	7.3	7.2	7.1	7.0	7.0	6.9	6.8

Ages												
	Male	98	99	100	101	102	103	104	105	106	107	108
Male	Female	103	104	105	106	107	108	109	110	111	112	113
60	65	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.2	18.2	18.2	18.2
61	66	17.7	17.7	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.6	17.5
62	67	17.0	17.0	17.0	17.0	17.0	17.0	16.9	16.9	16.9	16.9	16.9
63	68	16.4	16.4	16.4	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.2
64	69	15.8	15.8	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.6
65	70	15.2	15.2	15.1	15.1	15.1	15.1	15.1	15.1	15.1	15.0	15.0
66	71	14.6	14.6	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.4	14.4
67	72	14.0	14.0	14.0	14.0	13.9	13.9	13.9	13.9	13.9	13.9	13.8
68	73	13.5	13.4	13.4	13.4	13.4	13.4	13.3	13.3	13.3	13.3	13.2
69	74	12.9	12.9	12.9	12.8	12.8	12.8	12.8	12.8	12.8	12.7	12.7
70	75	12.4	12.4	12.3	12.3	12.3	12.3	12.3	12.2	12.2	12.2	12.1
71	76	11.9	11.9	11.8	11.8	11.8	11.8	11.7	11.7	11.7	11.7	11.6
72	77	11.4	11.4	11.3	11.3	11.3	11.3	11.2	11.2	11.2	11.2	11.1
73	78	10.9	10.9	10.9	10.8	10.8	10.8	10.7	10.7	10.7	10.7	10.6
74	79	10.5	10.4	10.4	10.4	10.3	10.3	10.3	10.3	10.2	10.2	10.1
75	80	10.0	10.0	9.9	9.9	9.9	9.8	9.8	9.8	9.8	9.7	-------
76	81	9.6	9.5	9.5	9.5	9.4	9.4	9.4	9.4	9.3	9.3	-------
77	82	9.2	9.1	9.1	9.1	9.0	9.0	9.0	8.9	8.9	8.9	-------
78	83	8.8	8.7	8.7	8.7	8.6	8.6	8.5	8.5	8.5	8.4	-------
79	84	8.4	8.4	8.3	8.3	8.2	8.2	8.2	8.1	8.1	8.0	-------
80	85	8.0	8.0	7.9	7.9	7.9	7.8	7.8	7.7	7.7	7.6	-------
81	86	7.7	7.6	7.6	7.6	7.5	7.5	7.4	7.4	7.3	7.3	-------
82	87	7.4	7.3	7.3	7.2	7.2	7.1	7.1	7.0	7.0	6.9	-------
83	88	7.1	7.0	6.9	6.9	6.8	6.8	6.7	6.7	6.7	6.6	-------
84	89	6.8	6.7	6.6	6.6	6.5	6.5	6.4	6.4	6.3	-------	-------

TABLE II.—ORDINARY JOINT LIFE AND LAST SURVIVOR ANNUITIES—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages: Male	Ages: Female	Male 86 / Female 91	87 / 92	88 / 93	89 / 94	90 / 95	91 / 96	92 / 97	93 / 98	94 / 99	95 / 100	96 / 101
85	90	7.9	7.7	7.5	7.4	7.2	7.1	7.0	6.9	6.8	6.7	6.6
86	91	7.7	7.5	7.3	7.1	7.0	6.8	6.7	6.6	6.5	6.4	6.4
87	92	7.5	7.3	7.1	6.9	6.8	6.6	6.5	6.4	6.3	6.2	6.1
88	93	7.3	7.1	6.9	6.7	6.6	6.4	6.3	6.2	6.1	6.0	5.9
89	94	7.1	6.9	6.7	6.5	6.4	6.2	6.1	6.0	5.9	5.8	5.7
90	95	7.0	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.6	5.5
91	96	6.8	6.6	6.4	6.2	6.1	5.9	5.8	5.7	5.5	5.4	5.3
92	97	6.7	6.5	6.3	6.1	5.9	5.8	5.6	5.5	5.4	5.3	5.2
93	98	6.6	6.4	6.2	6.0	5.8	5.7	5.5	5.4	5.2	5.1	5.0
94	99	6.5	6.3	6.1	5.9	5.7	5.5	5.4	5.2	5.1	5.0	4.9
95	100	6.4	6.2	6.0	5.8	5.6	5.4	5.3	5.1	5.0	4.9	4.7
96	101	6.4	6.1	5.9	5.7	5.5	5.3	5.2	5.0	4.9	4.7	4.6
97	102	6.3	6.1	5.8	5.6	5.4	5.2	5.1	4.9	4.8	4.6	4.5
98	103	6.2	6.0	5.8	5.5	5.3	5.1	5.0	4.8	4.7	4.5	4.4
99	104	6.2	5.9	5.7	5.5	5.2	5.1	4.9	4.7	4.6	4.4	4.3

Ages: Male	Ages: Female	Male 97 / Female 102	98 / 103	99 / 104	100 / 105	101 / 106	102 / 107	103 / 108	104 / 109	105 / 110	106 / 111
85	90	6.6	6.5	6.4	6.4	6.3	6.2	6.2	6.1	6.1	6.0
86	91	6.3	6.2	6.2	6.1	6.0	6.0	5.9	5.9	5.8	5.7
87	92	6.1	6.0	5.9	5.8	5.8	5.7	5.6	5.6	5.5	5.4
88	93	5.8	5.8	5.7	5.6	5.5	5.5	5.4	5.3	5.3	5.1
89	94	5.6	5.5	5.5	5.4	5.3	5.2	5.2	5.1	5.0	--------
90	95	5.4	5.3	5.2	5.2	5.1	5.0	4.9	4.9	4.8	--------
91	96	5.2	5.1	5.1	5.0	4.9	4.8	4.7	4.6	4.5	--------
92	97	5.1	5.0	4.9	4.8	4.7	4.6	4.5	4.4	--------	--------
93	98	4.9	4.8	4.7	4.6	4.5	4.4	4.3	4.2	--------	--------
94	99	4.8	4.7	4.6	4.5	4.4	4.3	4.1	--------	--------	--------
95	100	4.6	4.5	4.4	4.3	4.2	4.1	4.0	--------	--------	--------
96	101	4.5	4.4	4.3	4.2	4.1	3.9	--------	--------	--------	--------
97	102	4.4	4.3	4.1	4.0	3.9	3.7	--------	--------	--------	--------
98	103	4.3	4.1	4.0	3.9	3.7	--------	--------	--------	--------	--------
99	104	4.1	4.0	3.9	3.7	--------	--------	--------	--------	--------	--------

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES

Ages: Male	Ages: Female	Male 6 / Female 11	7 / 12	8 / 13	9 / 14	10 / 15	11 / 16	12 / 17	13 / 18	14 / 19	15 / 20	16 / 21	17 / 22	18 / 23	19 / 24	20 / 25
6	11	56.6	56.1	55.7	55.1	54.6	54.1	53.5	52.9	52.3	51.7	51.1	50.5	49.8	49.1	48.4
7	12	56.1	55.7	55.2	54.7	54.2	53.7	53.1	52.6	52.0	51.4	50.8	50.2	49.5	48.9	48.2
8	13	55.7	55.2	54.8	54.3	53.8	53.3	52.8	52.2	51.6	51.1	50.5	49.9	49.2	48.6	47.9
9	14	55.1	54.7	54.3	53.8	53.3	52.9	52.3	51.8	51.3	50.7	50.1	49.5	48.9	48.3	47.7
10	15	54.6	54.2	53.8	53.3	52.9	52.4	51.9	51.4	50.9	50.3	49.8	49.2	48.6	48.0	47.4
11	16	54.1	53.7	53.3	52.9	52.4	52.0	51.5	51.0	50.5	50.0	49.4	48.8	48.3	47.7	47.1
12	17	53.5	53.1	52.8	52.3	51.9	51.5	51.0	50.6	50.1	49.6	49.0	48.5	47.9	47.3	46.7
13	18	52.9	52.6	52.2	51.8	51.4	51.0	50.6	50.1	49.6	49.1	48.6	48.1	47.5	47.0	46.4
14	19	52.3	52.0	51.6	51.3	50.9	50.5	50.1	49.6	49.2	48.7	48.2	47.7	47.2	46.6	46.1
15	20	51.7	51.4	51.1	50.7	50.3	50.0	49.6	49.1	48.7	48.2	47.8	47.3	46.8	46.2	45.7
16	21	51.1	50.8	50.5	50.1	49.8	49.4	49.0	48.6	48.2	47.8	47.3	46.8	46.3	45.8	45.3
17	22	50.5	50.2	49.9	49.5	49.2	48.8	48.5	48.1	47.7	47.3	46.8	46.4	45.9	45.4	44.9
18	23	49.8	49.5	49.2	48.9	48.6	48.3	47.9	47.5	47.2	46.8	46.3	45.9	45.4	45.0	44.5
19	24	49.1	48.9	48.6	48.3	48.0	47.7	47.3	47.0	46.6	46.2	45.8	45.4	45.0	44.5	44.0
20	25	48.4	48.2	47.9	47.7	47.4	47.1	46.7	46.4	46.1	45.7	45.3	44.9	44.5	44.0	43.6

§ 1.72–9

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages Male	Ages Female	21 / 26	22 / 27	23 / 28	24 / 29	25 / 30	26 / 31	27 / 32	28 / 33	29 / 34	30 / 35	31 / 36	32 / 37	33 / 38	34 / 39
6	11	47.7	47.0	46.3	45.6	44.8	44.1	43.3	42.5	41.8	41.0	40.2	39.4	38.6	37.8
7	12	47.5	46.8	46.1	45.4	44.6	43.9	43.2	42.4	41.6	40.9	40.1	39.3	38.5	37.7
8	13	47.3	46.6	45.9	45.2	44.5	43.7	43.0	42.2	41.5	40.7	39.9	39.2	38.4	37.6
9	14	47.0	46.3	45.6	45.0	44.2	43.5	42.8	42.1	41.3	40.6	39.8	39.0	38.3	37.5
10	15	46.7	46.1	45.4	44.7	44.0	43.3	42.6	41.9	41.1	40.4	39.7	38.9	38.1	37.4
11	16	46.4	45.8	45.1	44.5	43.8	43.1	42.4	41.7	41.0	40.2	39.5	38.8	38.0	37.2
12	17	46.1	45.5	44.9	44.2	43.6	42.9	42.2	41.5	40.8	40.1	39.3	38.6	37.9	37.1
13	18	45.8	45.2	44.6	43.9	43.3	42.6	42.0	41.3	40.6	39.9	39.2	38.4	37.7	37.0
14	19	45.5	44.9	44.3	43.7	43.0	42.4	41.7	41.0	40.4	39.7	39.0	38.3	37.5	36.8
15	20	45.1	44.6	44.0	43.4	42.7	42.1	41.5	40.8	40.1	39.5	38.8	38.1	37.4	36.6
16	21	44.8	44.2	43.6	43.0	42.4	41.8	41.2	40.5	39.9	39.2	38.6	37.9	37.2	36.5
17	22	44.4	43.8	43.3	42.7	42.1	41.5	40.9	40.3	39.6	39.0	38.3	37.7	37.0	36.3
18	23	44.0	43.5	42.9	42.4	41.8	41.2	40.6	40.0	39.4	38.7	38.1	37.4	36.8	36.1
19	24	43.6	43.1	42.5	42.0	41.4	40.9	40.3	39.7	39.1	38.5	37.8	37.2	36.5	35.9
20	25	43.1	42.6	42.1	41.6	41.1	40.5	40.0	39.4	38.8	38.2	37.6	36.9	36.3	35.7
21	26	42.7	42.2	41.7	41.2	40.7	40.2	39.6	39.1	38.5	37.9	37.3	36.7	36.1	35.4
22	27	42.2	41.8	41.3	40.8	40.3	39.8	39.3	38.7	38.2	37.6	37.0	36.4	35.8	35.2
23	28	41.7	41.3	40.8	40.4	39.9	39.4	38.9	38.4	37.8	37.3	36.7	36.1	35.5	34.9
24	29	41.2	40.8	40.4	39.9	39.5	39.0	38.5	38.0	37.5	36.9	36.4	35.8	35.2	34.6
25	30	40.7	40.3	39.9	39.5	39.0	38.6	38.1	37.6	37.1	36.6	36.0	35.5	34.9	34.4
26	31	40.2	39.8	39.4	39.0	38.6	38.1	37.7	37.2	36.7	36.2	35.7	35.2	34.6	34.1
27	32	39.6	39.3	38.9	38.5	38.1	37.7	37.2	36.8	36.3	35.8	35.3	34.8	34.3	33.7
28	33	39.1	38.7	38.4	38.0	37.6	37.2	36.8	36.3	35.9	35.4	34.9	34.5	33.9	33.4
29	34	38.5	38.2	37.8	37.5	37.1	36.7	36.3	35.9	35.5	35.0	34.6	34.1	33.6	33.1
30	35	37.9	37.6	37.3	36.9	36.6	36.2	35.8	35.4	35.0	34.6	34.1	33.7	33.2	32.7
31	36	37.3	37.0	36.7	36.4	36.0	35.7	35.3	34.9	34.6	34.1	33.7	33.3	32.8	32.3
32	37	36.7	36.4	36.1	35.8	35.5	35.2	34.8	34.5	34.1	33.7	33.3	32.9	32.4	32.0
33	38	36.1	35.8	35.5	35.2	34.9	34.6	34.3	33.9	33.6	33.2	32.8	32.4	32.0	31.6
34	39	35.4	35.2	34.9	34.6	34.4	34.1	33.7	33.4	33.1	32.7	32.3	32.0	31.6	31.1

Ages Male	Ages Female	35 / 40	36 / 41	37 / 42	38 / 43	39 / 44	40 / 45	41 / 46	42 / 47	43 / 48	44 / 49	45 / 50	46 / 51	47 / 52	48 / 53	49 / 54
6	11	37.0	36.2	35.4	34.6	33.8	33.0	32.2	31.4	30.6	29.8	29.0	28.2	27.5	26.7	25.9
7	12	36.9	36.1	35.3	34.5	33.7	32.9	32.1	31.3	30.5	29.8	29.0	28.2	27.4	26.7	25.9
8	13	36.8	36.0	35.2	34.4	33.7	32.9	32.1	31.3	30.5	29.7	28.9	28.2	27.4	26.6	25.9
9	14	36.7	35.9	35.1	34.4	33.6	32.8	32.0	31.2	30.4	29.7	28.9	28.1	27.3	26.6	25.8
10	15	36.6	35.8	35.1	34.3	33.5	32.7	31.9	31.2	30.4	29.6	28.8	28.1	27.3	26.5	25.8
11	16	36.5	35.7	34.9	34.2	33.4	32.6	31.9	31.1	30.3	29.5	28.8	28.0	27.3	26.5	25.7
12	17	36.4	35.6	34.8	34.1	33.3	32.5	31.8	31.0	30.2	29.5	28.7	28.0	27.2	26.4	25.7
13	18	36.2	35.5	34.7	34.0	33.2	32.4	31.7	30.9	30.2	29.4	28.7	27.9	27.1	26.4	25.7
14	19	36.1	35.3	34.6	33.8	33.1	32.3	31.6	30.8	30.1	29.3	28.6	27.8	27.1	26.3	25.6
15	20	35.9	35.2	34.5	33.7	33.0	32.2	31.5	30.7	30.0	29.3	28.5	27.8	27.0	26.3	25.6
16	21	35.8	35.0	34.3	33.6	32.9	32.1	31.4	30.6	29.9	29.2	28.4	27.7	27.0	26.2	25.5
17	22	35.6	34.9	34.2	33.4	32.7	32.0	31.3	30.5	29.8	29.1	28.3	27.6	26.9	26.2	25.4
18	23	35.4	34.7	34.0	33.3	32.6	31.9	31.2	30.4	29.7	29.0	28.3	27.5	26.8	26.1	25.4
19	24	35.2	34.5	33.8	33.1	32.4	31.7	31.0	30.3	29.6	28.9	28.2	27.4	26.7	26.0	25.3
20	25	35.0	34.3	33.7	33.0	32.3	31.6	30.9	30.2	29.5	28.8	28.1	27.3	26.6	25.9	25.2
21	26	34.8	34.1	33.5	32.8	32.1	31.4	30.7	30.0	29.3	28.6	27.9	27.2	26.5	25.8	25.1
22	27	34.5	33.9	33.3	32.6	31.9	31.3	30.6	29.9	29.2	28.5	27.8	27.1	26.4	25.7	25.1
23	28	34.3	33.7	33.0	32.4	31.7	31.1	30.4	29.7	29.1	28.4	27.7	27.0	26.3	25.6	25.0
24	29	34.0	33.4	32.8	32.2	31.5	30.9	30.2	29.6	28.9	28.2	27.6	26.9	26.2	25.5	24.9
25	30	33.8	33.2	32.6	32.0	31.3	30.7	30.1	29.4	28.8	28.1	27.4	26.8	26.1	25.4	24.8
26	31	33.5	32.9	32.3	31.7	31.1	30.5	29.9	29.2	28.6	27.9	27.3	26.6	26.0	25.3	24.6
27	32	33.2	32.6	32.1	31.5	30.9	30.3	29.6	29.0	28.4	27.8	27.1	26.5	25.8	25.2	24.5
28	33	32.9	32.3	31.8	31.2	30.6	30.0	29.4	28.8	28.2	27.6	27.0	26.3	25.7	25.0	24.4
29	34	32.6	32.0	31.5	30.9	30.4	29.8	29.2	28.6	28.0	27.4	26.8	26.2	25.5	24.9	24.3
30	35	32.2	31.7	31.2	30.6	30.1	29.5	29.0	28.4	27.8	27.2	26.6	26.0	25.4	24.7	24.1
31	36	31.9	31.4	30.9	30.3	29.8	29.3	28.7	28.1	27.6	27.0	26.4	25.8	25.2	24.6	24.0
32	37	31.5	31.0	30.5	30.0	29.5	29.0	28.4	27.9	27.3	26.8	26.2	25.6	25.0	24.4	23.8
33	38	31.1	30.7	30.2	29.7	29.2	28.7	28.2	27.6	27.1	26.5	26.0	25.4	24.8	24.2	23.6
34	39	30.7	30.3	29.8	29.3	28.9	28.4	27.9	27.3	26.8	26.3	25.7	25.2	24.6	24.0	23.5

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	Male	50	51	52	53	54	55	56	57	58	59	60	61	62	63
Male	Female	55	56	57	58	59	60	61	62	63	64	65	66	67	68
6	11	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1
7	12	25.1	24.4	23.6	22.9	22.2	21.5	20.8	20.1	19.4	18.7	18.0	17.4	16.7	16.1
8	13	25.1	24.4	23.6	22.9	22.2	21.4	20.7	20.0	19.4	18.7	18.0	17.4	16.7	16.1
9	14	25.1	24.3	23.6	22.9	22.1	21.4	20.7	20.0	19.3	18.7	18.0	17.3	16.7	16.1
10	15	25.0	24.3	23.6	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1
11	16	25.0	24.3	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.1
12	17	25.0	24.2	23.5	22.8	22.1	21.4	20.7	20.0	19.3	18.6	18.0	17.3	16.7	16.0
13	18	24.9	24.2	23.5	22.7	22.0	21.3	20.6	19.9	19.3	18.6	17.9	17.3	16.7	16.0
14	19	24.9	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.6	17.9	17.3	16.6	16.0
15	20	24.8	24.1	23.4	22.7	22.0	21.3	20.6	19.9	19.2	18.5	17.9	17.3	16.6	16.0
16	21	24.8	24.0	23.3	22.6	21.9	21.2	20.5	19.9	19.2	18.5	17.9	17.2	16.6	16.0
17	22	24.7	24.0	23.3	22.6	21.9	21.2	20.5	19.8	19.2	18.5	17.8	17.2	16.6	16.0
18	23	24.7	23.9	23.2	22.5	21.8	21.1	20.5	19.8	19.1	18.5	17.8	17.2	16.6	15.9
19	24	24.6	23.9	23.2	22.5	21.8	21.1	20.4	19.8	19.1	18.4	17.8	17.2	16.5	15.9
20	25	24.5	23.8	23.1	22.4	21.7	21.1	20.4	19.7	19.1	18.4	17.8	17.1	16.5	15.9
21	26	24.4	23.7	23.1	22.4	21.7	21.0	20.3	19.7	19.0	18.4	17.7	17.1	16.5	15.9
22	27	24.4	23.7	23.0	22.3	21.6	21.0	20.3	19.6	19.0	18.3	17.7	17.1	16.5	15.9
23	28	24.3	23.6	22.9	22.2	21.6	20.9	20.2	19.6	18.9	18.3	17.7	17.0	16.4	15.8
24	29	24.2	23.5	22.8	22.2	21.5	20.8	20.2	19.5	18.9	18.3	17.6	17.0	16.4	15.8
25	30	24.1	23.4	22.8	22.1	21.4	20.8	20.1	19.5	18.8	18.2	17.6	17.0	16.4	15.8
26	31	24.0	23.3	22.7	22.0	21.4	20.7	20.1	19.4	18.8	18.2	17.5	16.9	16.3	15.7
27	32	23.9	23.2	22.6	21.9	21.3	20.6	20.0	19.4	18.7	18.1	17.5	16.9	16.3	15.7
28	33	23.8	23.1	22.5	21.8	21.2	20.6	19.9	19.3	18.7	18.1	17.4	16.8	16.2	15.6
29	34	23.6*	23.0	22.4	21.7	21.1	20.5	19.8	19.2	18.6	18.0	17.4	16.8	16.2	15.6
30	35	23.5	22.9	22.3	21.6	21.0	20.4	19.8	19.1	18.5	17.9	17.3	16.7	16.1	15.6
31	36	23.4	22.7	22.1	21.5	20.9	20.3	19.7	19.1	18.5	17.9	17.3	16.7	16.1	15.5
32	37	23.2	22.6	22.0	21.4	20.8	20.2	19.6	19.0	18.4	17.8	17.2	16.6	16.0	15.5
33	38	23.1	22.5	21.9	21.3	20.7	20.1	19.5	18.9	18.3	17.7	17.1	16.5	16.0	15.4
34	39	22.9	22.3	21.7	21.1	20.5	20.0	19.4	18.8	18.2	17.6	17.0	16.5	15.9	15.3

Ages	Male	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78
Male	Female	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83
6	11	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
7	12	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
8	13	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.6	9.1	8.7	8.2
9	14	15.5	14.9	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
10	15	15.4	14.8	14.3	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
11	16	15.4	14.8	14.2	13.7	13.1	12.6	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.7	8.2
12	17	15.4	14.8	14.2	13.7	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
13	18	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
14	19	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
15	20	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
16	21	15.4	14.8	14.2	13.6	13.1	12.5	12.0	11.5	11.0	10.5	10.0	9.5	9.1	8.6	8.2
17	22	15.4	14.8	14.2	13.6	13.0	12.5	12.0	11.5	10.9	10.5	10.0	9.5	9.1	8.6	8.2
18	23	15.3	14.7	14.2	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
19	24	15.3	14.7	14.1	13.6	13.0	12.5	12.0	11.4	10.9	10.4	10.0	9.5	9.1	8.6	8.2
20	25	15.3	14.7	14.1	13.6	13.0	12.5	11.9	11.4	10.9	10.4	10.0	9.5	9.0	8.6	8.2
21	26	15.3	14.7	14.1	13.5	13.0	12.5	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
22	27	15.3	14.7	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
23	28	15.2	14.6	14.1	13.5	13.0	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
24	29	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
25	30	15.2	14.6	14.0	13.5	12.9	12.4	11.9	11.4	10.9	10.4	9.9	9.5	9.0	8.6	8.2
26	31	15.1	14.6	14.0	13.4	12.9	12.4	11.9	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
27	32	15.1	14.5	14.0	13.4	12.9	12.4	11.8	11.3	10.8	10.4	9.9	9.4	9.0	8.6	8.2
28	33	15.1	14.5	13.9	13.4	12.9	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.6	8.1
29	34	15.0	14.5	13.9	13.4	12.8	12.3	11.8	11.3	10.8	10.3	9.9	9.4	9.0	8.5	8.1
30	35	15.0	14.4	13.9	13.3	12.8	12.3	11.8	11.3	10.8	10.3	9.8	9.4	9.0	8.5	8.1
31	36	14.9	14.4	13.8	13.3	12.8	12.2	11.7	11.2	10.8	10.3	9.8	9.4	8.9	8.5	8.1
32	37	14.9	14.3	13.8	13.3	12.7	12.2	11.7	11.2	10.7	10.3	9.8	9.4	8.9	8.5	8.1
33	38	14.8	14.3	13.8	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1
34	39	14.8	14.2	13.7	13.2	12.7	12.2	11.7	11.2	10.7	10.2	9.8	9.3	8.9	8.5	8.1

*Erroneously shown as 26.6 in T. D. 6211; corrected by T. D. 6233.

§ 1.72–9

Table IIA.—Annuities for Joint Life Only—Two Lives—Expected Return Multiples—Continued

Ages Male	Male Female	79 84	80 85	81 86	82 87	83 88	84 89	85 90	86 91	87 92	88 93	89 94	90 95	91 96	92 97	93 98
6	11	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
7	12	7.8	7.4	7.1	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
8	13	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
9	14	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
10	15	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
11	16	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
12	17	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.4	5.1	4.8	4.5	4.2	4.0	3.7	3.5
13	18	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.1	4.8	4.5	4.2	4.0	3.7	3.5
14	19	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
15	20	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
16	21	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
17	22	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
18	23	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
19	24	7.8	7.4	7.0	6.7	6.3	6.0	5.7	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
20	25	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
21	26	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
22	27	7.8	7.4	7.0	6.7	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
23	28	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.8	4.5	4.2	4.0	3.7	3.5
24	29	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
25	30	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
26	31	7.8	7.4	7.0	6.6	6.3	6.0	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
27	32	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
28	33	7.7	7.4	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
29	34	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
30	35	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
31	36	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
32	37	7.7	7.3	7.0	6.6	6.3	5.9	5.6	5.3	5.0	4.7	4.5	4.2	4.0	3.7	3.5
33	38	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.5	4.2	3.9	3.7	3.5
34	39	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3	5.0	4.7	4.4	4.2	3.9	3.7	3.5

Ages Male	Male Female	94 99	95 100	96 101	97 102	98 103	99 104	100 105	101 106	102 107	103 108	104 109	105 110	106 111	107 112	108 113
6	11	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
7	12	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
8	13	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
9	14	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
10	15	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
11	16	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
12	17	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
13	18	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
14	19	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
15	20	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
16	21	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
17	22	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
18	23	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
19	24	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
20	25	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
21	26	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
22	27	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
23	28	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
24	29	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
25	30	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
26	31	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
27	32	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
28	33	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
29	34	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
30	35	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
31	36	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
32	37	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
33	38	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
34	39	3.3	3.1	2.9	2.7	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages	Male	35	36	37	38	39	40	41	42	43	44	45	46	47
Male	Female	40	41	42	43	44	45	46	47	48	49	50	51	52
35	40	30.3	29.9	29.4	29.0	28.5	28.0	27.5	27.0	26.5	26.0	25.5	24.9	24.4
36	41	29.9	29.5	29.0	28.6	28.2	27.7	27.2	26.7	26.2	25.7	25.2	24.7	24.2
37	42	29.4	29.0	28.6	28.2	27.8	27.3	26.9	26.4	25.9	25.5	25.0	24.4	23.9
38	43	29.0	28.6	28.2	27.8	27.4	27.0	26.5	26.1	25.6	25.2	24.7	24.2	23.7
39	44	28.5	28.2	27.8	27.4	27.0	26.6	26.2	25.8	25.3	24.8	24.4	23.9	23.4
40	45	28.0	27.7	27.3	27.0	26.6	26.2	25.8	25.4	25.0	24.5	24.1	23.6	23.1
41	46	27.5	27.2	26.9	26.5	26.2	25.8	25.4	25.0	24.6	24.2	23.8	23.3	22.9
42	47	27.0	26.7	26.4	26.1	25.8	25.4	25.0	24.6	24.2	23.8	23.4	23.0	22.6
43	48	26.5	26.2	25.9	25.6	25.3	25.0	24.6	24.2	23.9	23.5	23.1	22.7	22.2
44	49	26.0	25.7	25.5	25.2	24.8	24.5	24.2	23.8	23.5	23.1	22.7	22.3	21.9
45	50	25.5	25.2	25.0	24.7	24.4	24.1	23.8	23.4	23.1	22.7	22.4	22.0	21.6
46	51	24.9	24.7	24.4	24.2	23.9	23.6	23.3	23.0	22.7	22.3	22.0	21.6	21.2
47	52	24.4	24.2	23.9	23.7	23.4	23.1	22.9	22.6	22.2	21.9	21.6	21.2	20.9

Ages	Male	48	49	50	51	52	53	54	55	56	57	58	59	60
Male	Female	53	54	55	56	57	58	59	60	61	62	63	64	65
35	40	23.8	23.3	22.7	22.1	21.6	21.0	20.4	19.8	19.3	18.7	18.1	17.5	17.0
36	41	23.6	23.1	22.5	22.0	21.4	20.8	20.3	19.7	19.1	18.6	18.0	17.4	16.9
37	42	23.4	22.9	22.3	21.8	21.2	20.7	20.1	19.6	19.0	18.4	17.9	17.3	16.8
38	43	23.2	22.6	22.1	21.6	21.1	20.5	20.0	19.4	18.9	18.3	17.8	17.2	16.7
39	44	22.9	22.4	21.9	21.4	20.9	20.3	19.8	19.3	18.7	18.2	17.7	17.1	16.6
40	45	22.7	22.2	21.7	21.2	20.7	20.1	19.6	19.1	18.6	18.0	17.5	17.0	16.5
41	46	22.4	21.9	21.4	20.9	20.4	19.9	19.4	18.9	18.4	17.9	17.4	16.9	16.3
42	47	22.1	21.6	21.2	20.7	20.2	19.7	19.2	18.7	18.2	17.7	17.2	16.7	16.2
43	48	21.8	21.4	20.9	20.5	20.0	19.5	19.0	18.6	18.1	17.6	17.1	16.6	16.1
44	49	21.5	21.1	20.6	20.2	19.8	19.3	18.8	18.4	17.9	17.4	16.9	16.4	15.9
45	50	21.2	20.8	20.4	19.9	19.5	19.1	18.6	18.1	17.7	17.2	16.7	16.3	15.8
46	51	20.9	20.5	20.1	19.7	19.2	18.8	18.4	17.9	17.5	17.0	16.6	16.1	15.6
47	52	20.5	20.1	19.8	19.4	19.0	18.5	18.1	17.7	17.3	16.8	16.4	15.9	15.5
48	53	20.2	19.8	19.4	19.1	18.7	18.3	17.9	17.5	17.0	16.6	16.2	15.7	15.3
49	54	19.8	19.5	19.1	18.8	18.4	18.0	17.6	17.2	16.8	16.4	16.0	15.5	15.1
50	55	19.4	19.1	18.8	18.4	18.1	17.7	17.3	16.9	16.6	16.2	15.8	15.3	14.9
51	56	19.1	18.8	18.4	18.1	17.8	17.4	17.0	16.7	16.3	15.9	15.5	15.1	14.7
52	57	18.7	18.4	18.1	17.8	17.4	17.1	16.8	16.4	16.0	15.7	15.3	14.9	14.5
53	58	18.3	18.0	17.7	17.4	17.1	16.8	16.4	16.1	15.8	15.4	15.1	14.7	14.3
54	59	17.9	17.6	17.3	17.0	16.8	16.4	16.1	15.8	15.5	15.1	14.8	14.4	14.1
55	60	17.5	17.2	16.9	16.7	16.4	16.1	15.8	15.5	15.2	14.9	14.5	14.2	13.9
56	61	17.0	16.8	16.6	16.3	16.0	15.8	15.5	15.2	14.9	14.6	14.3	13.9	13.6
57	62	16.6	16.4	16.2	15.9	15.7	15.4	15.1	14.9	14.6	14.3	14.0	13.7	13.4
58	63	16.2	16.0	15.8	15.5	15.3	15.1	14.8	14.5	14.3	14.0	13.7	13.4	13.1
59	64	15.7	15.5	15.3	15.1	14.9	14.7	14.4	14.2	13.9	13.7	13.4	13.1	12.8
60	65	15.3	15.1	14.9	14.7	14.5	14.3	14.1	13.9	13.6	13.4	13.1	12.8	12.6

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages														
	Male	61	62	63	64	65	66	67	68	69	70	71	72	73
Male	Female	66	67	68	69	70	71	72	73	74	75	76	77	78
35	40	16.4	15.8	15.3	14.7	14.2	13.7	13.1	12.6	12.1	11.6	11.1	10.7	10.2
36	41	16.3	15.8	15.2	14.7	14.1	13.6	13.1	12.6	12.1	11.6	11.1	10.6	10.2
37	42	16.2	15.7	15.1	14.6	14.1	13.6	13.0	12.5	12.0	11.5	11.1	10.6	10.1
38	43	16.1	15.6	15.1	14.5	14.0	13.5	13.0	12.5	12.0	11.5	11.0	10.6	10.1
39	44	16.0	15.5	15.0	14.5	13.9	13.4	12.9	12.4	11.9	11.5	11.0	10.5	10.1
40	45	15.9	15.4	14.9	14.4	13.9	13.4	12.9	12.4	11.9	11.4	11.0	10.5	10.0
41	46	15.8	15.3	14.8	14.3	13.8	13.3	12.8	12.3	11.8	11.4	10.9	10.5	10.0
42	47	15.7	15.2	14.7	14.2	13.7	13.2	12.7	12.3	11.8	11.3	10.9	10.4	10.0
43	48	15.6	15.1	14.6	14.1	13.6	13.1	12.7	12.2	11.7	11.3	10.8	10.4	9.9
44	49	15.5	15.0	14.5	14.0	13.5	13.1	12.6	12.1	11.7	11.2	10.8	10.3	9.9
45	50	15.3	14.8	14.4	13.9	13.4	13.0	12.5	12.0	11.6	11.1	10.7	10.3	9.8
46	51	15.2	14.7	14.2	13.8	13.3	12.9	12.4	12.0	11.5	11.1	10.6	10.2	9.8
47	52	15.0	14.6	14.1	13.7	13.2	12.8	12.3	11.9	11.4	11.0	10.6	10.1	9.7
48	53	14.9	14.4	14.0	13.5	13.1	12.6	12.2	11.8	11.3	10.9	10.5	10.1	9.7
49	54	14.7	14.3	13.8	13.4	13.0	12.5	12.1	11.7	11.3	10.8	10.4	10.0	9.6
50	55	14.5	14.1	13.7	13.3	12.8	12.4	12.0	11.6	11.2	10.7	10.3	9.9	9.5
51	56	14.3	13.9	13.5	13.1	12.7	12.3	11.9	11.5	11.1	10.7	10.3	9.9	9.5
52	57	14.1	13.7	13.3	12.9	12.5	12.1	11.7	11.3	10.9	10.6	10.2	9.8	9.4
53	58	13.9	13.6	13.2	12.8	12.4	12.0	11.6	11.2	10.8	10.5	10.1	9.7	9.3
54	59	13.7	13.4	13.0	12.6	12.2	11.9	11.5	11.1	10.7	10.3	10.0	9.6	9.2
55	60	13.5	13.2	12.8	12.4	12.1	11.7	11.3	11.0	10.6	10.2	9.9	9.5	9.1
56	61	13.3	12.9	12.6	12.2	11.9	11.5	11.2	10.8	10.5	10.1	9.8	9.4	9.0
57	62	13.0	12.7	12.4	12.1*	11.7	11.4	11.0	10.7	10.3	10.0	9.6	9.3	8.9
58	63	12.8	12.5	12.2	11.8	11.5	11.2	10.9	10.5	10.2	9.8	9.5	9.2	8.8
59	64	12.6	12.3	11.9	11.6	11.3	11.0	10.7	10.4	10.0	9.7	9.4	9.1	8.7
60	65	12.3	12.0	11.7	11.4	11.1	10.8	10.5	10.2	9.9	9.6	9.3	8.9	8.6
61	66	12.0	11.8	11.5	11.2	10.9	10.6	10.3	10.0	9.7	9.4	9.1	8.8	8.5
62	67	11.8	11.5	11.2	11.0	10.7	10.4	10.1	9.8	9.6	9.3	9.0	8.7	8.4
63	68	11.5	11.2	11.0	10.7	10.5	10.2	9.9	9.7	9.4	9.1	8.8	8.5	8.2
64	69	11.2	11.0	10.7	10.5	10.2	10.0	9.7	9.5	9.2	8.9	8.7	8.4	8.1
65	70	10.9	10.7	10.5	10.2	10.0	9.8	9.5	9.3	9.0	8.8	8.5	8.2	8.0
66	71	10.6	10.4	10.2	10.0	9.8	9.5	9.3	9.1	8.8	8.6	8.3	8.1	7.8
67	72	10.3	10.1	9.9	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.1	7.9	7.7
68	73	10.0	9.8	9.7	9.5	9.3	9.1	8.9	8.6	8.4	8.2	8.0	7.7	7.5
69	74	9.7	9.6	9.4	9.2	9.0	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.3
70	75	9.4	9.3	9.1	8.9	8.8	8.6	8.4	8.2	8.0	7.8	7.6	7.4	7.2
71	76	9.1	9.0	8.8	8.7	8.5	8.3	8.1	8.0	7.8	7.6	7.4	7.2	7.0
72	77	8.8	8.7	8.5	8.4	8.2	8.1	7.9	7.7	7.6	7.4	7.2	7.0	6.8
73	78	8.5	8.4	8.2	8.1	8.0	7.8	7.7	7.5	7.3	7.2	7.0	6.8	6.7

*Erroneously shown as 12.0 in T. D. 6211 ; corrected by T. D. 6233.

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages														
	Male	74	75	76	77	78	79	80	81	82	83	84	85	86
Male	Female	79	80	81	82	83	84	85	86	87	88	89	90	91
35	40	9.7	9.3	8.9	8.5	8.1	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
36	41	9.7	9.3	8.9	8.4	8.0	7.7	7.3	6.9	6.6	6.2	5.9	5.6	5.3
37	42	9.7	9.3	8.8	8.4	8.0	7.6	7.3	6.9	6.5	6.2	5.9	5.6	5.3
38	43	9.7	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
39	44	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.6	5.3
40	45	9.6	9.2	8.8	8.4	8.0	7.6	7.2	6.9	6.5	6.2	5.9	5.5	5.2
41	46	9.6	9.2	8.7	8.3	7.9	7.6	7.2	6.8	6.5	6.2	5.8	5.5	5.2
42	47	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.2	5.8	5.5	5.2
43	48	9.5	9.1	8.7	8.3	7.9	7.5	7.2	6.8	6.5	6.1	5.8	5.5	5.2
44	49	9.5	9.0	8.6	8.2	7.9	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
45	50	9.4	9.0	8.6	8.2	7.8	7.5	7.1	6.8	6.4	6.1	5.8	5.5	5.2
46	51	9.4	9.0	8.6	8.2	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
47	52	9.3	8.9	8.5	8.1	7.8	7.4	7.1	6.7	6.4	6.1	5.8	5.5	5.2
48	53	9.3	8.9	8.5	8.1	7.7	7.4	7.0	6.7	6.4	6.0	5.7	5.4	5.1
49	54	9.2	8.8	8.4	8.1	7.7	7.3	7.0	6.7	6.3	6.0	5.7	5.4	5.1
50	55	9.1	8.8	8.4	8.0	7.7	7.3	7.0	6.6	6.3	6.0	5.7	5.4	5.1
51	56	9.1	8.7	8.3	8.0	7.6	7.3	6.9	6.6	6.3	6.0	5.7	5.4	5.1
52	57	9.0	8.6	8.3	7.9	7.6	7.2	6.9	6.6	6.2	5.9	5.6	5.4	5.1
53	58	8.9	8.6	8.2	7.9	7.5	7.2	6.9	6.5	6.2	5.9	5.6	5.3	5.1
54	59	8.9	8.5	8.2	7.8	7.5	7.1	6.8	6.5	6.2	5.9	5.6	5.3	5.0
55	60	8.8	8.4	8.1	7.7	7.4	7.1	6.8	6.4	6.1	5.8	5.6	5.3	5.0
56	61	8.7	8.4	8.0	7.7	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.3	5.0
57	62	8.6	8.3	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.8	5.5	5.2	5.0
58	63	8.5	8.2	7.9	7.5	7.2	6.9	6.6	6.3	6.0	5.7	5.5	5.2	4.9
59	64	8.4	8.1	7.8	7.5	7.1	6.8	6.5	6.3	6.0	5.7	5.4	5.2	4.9
60	65	8.3	8.0	7.7	7.4	7.1	6.8	6.5	6.2	5.9	5.6	5.4	5.1	4.9
61	66	8.2	7.9	7.6	7.3	7.0	6.7	6.4	6.1	5.9	5.6	5.3	5.1	4.8
62	67	8.1	7.8	7.5	7.2	6.9	6.6	6.4	6.1	5.8	5.5	5.3	5.0	4.8
63	68	8.0	7.7	7.4	7.1	6.8	6.6	6.3	6.0	5.7	5.5	5.2	5.0	4.7
64	69	7.8	7.6	7.3	7.0	6.7	6.5	6.2	5.9	5.7	5.4	5.2	4.9	4.7
65	70	7.7	7.4	7.2	6.9	6.6	6.4	6.1	5.9	5.6	5.4	5.1	4.9	4.7
66	71	7.6	7.3	7.1	6.8	6.5	6.3	6.0	5.8	5.5	5.3	5.1	4.8	4.6
67	72	7.4	7.2	6.9	6.7	6.4	6.2	6.0	5.7	5.5	5.2	5.0	4.8	4.6
68	73	7.3	7.0	6.8	6.6	6.3	6.1	5.9	5.6	5.4	5.2	4.9	4.7	4.5
69	74	7.1	6.9	6.7	6.4	6.2	6.0	5.8	5.5	5.3	5.1	4.9	4.7	4.5
70	75	7.0	6.8	6.5	6.3	6.1	5.9	5.7	5.4	5.2	5.0	4.8	4.6	4.4
71	76	6.8	6.6	6.4	6.2	6.0	5.8	5.6	5.3	5.1	4.9	4.7	4.5	4.3
72	77	6.6	6.4	6.3	6.1	5.9	5.7	5.5	5.3	5.0	4.9	4.7	4.5	4.3
73	78	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.1	5.0	4.8	4.6	4.4	4.2
74	79	6.3	6.1	6.0	5.8	5.6	5.4	5.2	5.0	4.9	4.7	4.5	4.3	4.1
75	80	6.1	6.0	5.8	5.6	5.5	5.3	5.1	4.9	4.8	4.6	4.4	4.2	4.1
76	81	6.0	5.8	5.6	5.5	5.3	5.2	5.0	4.8	4.7	4.5	4.3	4.1	4.0
77	82	5.8	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.5	4.4	4.2	4.1	3.9
78	83	5.6	5.5	5.3	5.2	5.0	4.9	4.7	4.6	4.4	4.3	4.1	4.0	3.8
79	84	5.4	5.3	5.2	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.0	3.9	3.7
80	85	5.2	5.1	5.0	4.9	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.6
81	86	5.0	4.9	4.8	4.7	4.6	4.5	4.3	4.2	4.1	3.9	3.8	3.7	3.6
82	87	4.9	4.8	4.7	4.5	4.4	4.3	4.2	4.1	4.0	3.8	3.7	3.6	3.5
83	88	4.7	4.6	4.5	4.4	4.3	4.2	4.1	3.9	3.8	3.7	3.6	3.5	3.4
84	89	4.5	4.4	4.3	4.2	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3
85	90	4.3	4.2	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.5	3.4	3.3	3.2
86	91	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.6	3.5	3.4	3.3	3.2	3.1

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages												
	Male	87	88	89	90	91	92	93	94	95	96	97
Male	Female	92	93	94	95	96	97	98	99	100	101	102
35	40	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
36	41	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
37	42	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7
38	43	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.8	2.6
39	44	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
40	45	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.3	3.0	2.8	2.6
41	46	5.0	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
42	47	4.9	4.7	4.4	4.2	3.9	3.7	3.5	3.2	3.0	2.8	2.6
43	48	4.9	4.7	4.4	4.1	3.9	3.7	3.5	3.2	3.0	2.8	2.6
44	49	4.9	4.7	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
45	50	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
46	51	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
47	52	4.9	4.6	4.4	4.1	3.9	3.7	3.4	3.2	3.0	2.8	2.6
48	53	4.9	4.6	4.4	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
49	54	4.9	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
50	55	4.8	4.6	4.3	4.1	3.9	3.6	3.4	3.2	3.0	2.8	2.6
51	56	4.8	4.6	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
52	57	4.8	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.8	2.6
53	58	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
54	59	4.8	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
55	60	4.7	4.5	4.3	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6
56	61	4.7	4.5	4.2	4.0	3.8	3.6	3.3	3.1	2.9	2.8	2.6
57	62	4.7	4.5	4.2	4.0	3.8	3.5	3.3	3.1	2.9	2.7	2.6
58	63	4.7	4.4	4.2	4.0	3.7	3.5	3.3	3.1	2.9	2.7	2.5
59	64	4.6	4.4	4.2	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5

Ages												
	Male	98	99	100	101	102	103	104	105	106	107	108
Male	Female	103	104	105	106	107	108	109	110	111	112	113
35	40	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	0.8	0.7
36	41	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.2	1.0	.8	.7
37	42	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
38	43	2.5	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
39	44	2.4	2.3	2.1	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
40	45	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
41	46	2.4	2.2	2.1	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
42	47	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
43	48	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
44	49	2.4	2.2	2.0	1.9	1.7	1.5	1.3	1.1	1.0	.8	.7
45	50	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	.8	.7
46	51	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	.8	.7
47	52	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	.8	.7
48	53	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	.8	.7
49	54	2.4	2.2	2.0	1.8	1.7	1.5	1.3	1.1	1.0	.8	.7
50	55	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	.8	.7
51	56	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	.8	.7
52	57	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	.8	.7
53	58	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	.8	.7
54	59	2.4	2.2	2.0	1.8	1.6	1.5	1.3	1.1	1.0	.8	.7
55	60	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	.8	.7
56	61	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	1.0	.8	.7
57	62	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	0.9	.8	.7
58	63	2.4	2.2	2.0	1.8	1.6	1.4	1.3	1.1	.9	.8	.7
59	64	2.3	2.2	2.0	1.8	1.6	1.4	1.3	1.1	.9	.8	.7

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages: Male	Ages: Female	87 / 92	88 / 93	89 / 94	90 / 95	91 / 96	92 / 97	93 / 98	94 / 99	95 / 100	96 / 101	97 / 102
60	65	4.6	4.4	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
61	66	4.6	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
62	67	4.5	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.7	2.5
63	68	4.5	4.3	4.1	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5
64	69	4.5	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.7	2.5
65	70	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.5
66	71	4.4	4.2	4.0	3.8	3.6	3.4	3.2	3.0	2.8	2.6	2.4
67	72	4.3	4.1	3.9	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.4
68	73	4.3	4.1	3.9	3.7	3.5	3.3	3.1	2.9	2.8	2.6	2.4
69	74	4.2	4.0	3.8	3.6	3.5	3.3	3.1	2.9	2.7	2.6	2.4
70	75	4.2	4.0	3.8	3.6	3.4	3.2	3.1	2.9	2.7	2.5	2.4
71	76	4.1	3.9	3.8	3.6	3.4	3.2	3.0	2.9	2.7	2.5	2.3
72	77	4.1	3.9	3.7	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.3
73	78	4.0	3.8	3.7	3.5	3.3	3.1	3.0	2.8	2.6	2.5	2.3
74	79	3.9	3.8	3.6	3.4	3.3	3.1	2.9	2.8	2.6	2.4	2.3
75	80	3.9	3.7	3.5	3.4	3.2	3.0	2.9	2.7	2.6	2.4	2.2
76	81	3.8	3.6	3.5	3.3	3.2	3.0	2.8	2.7	2.5	2.4	2.2
77	82	3.7	3.6	3.4	3.3	3.1	3.0	2.8	2.6	2.5	2.3	2.2
78	83	3.7	3.5	3.4	3.2	3.1	2.9	2.7	2.6	2.4	2.3	2.1
79	84	3.6	3.4	3.3	3.1	3.0	2.8	2.7	2.5	2.4	2.2	2.1
80	85	3.5	3.4	3.2	3.1	2.9	2.8	2.6	2.5	2.3	2.2	2.0
81	86	3.4	3.3	3.1	3.0	2.9	2.7	2.6	2.4	2.3	2.1	2.0
82	87	3.3	3.2	3.1	2.9	2.8	2.7	2.5	2.4	2.2	2.1	2.0
83	88	3.2	3.1	3.0	2.9	2.7	2.6	2.5	2.3	2.2	2.0	1.9
84	89	3.1	3.0	2.9	2.8	2.7	2.5	2.4	2.3	2.1	2.0	1.9

Ages: Male	Ages: Female	98 / 103	99 / 104	100 / 105	101 / 106	102 / 107	103 / 108	104 / 109	105 / 110	106 / 111	107 / 112	108 / 113
60	65	2.3	2.1	2.0	1.8	1.6	1.4	1.3	1.1	0.9	0.8	0.7
61	66	2.3	2.1	2.0	1.8	1.6	1.4	1.2	1.1	.9	.8	.7
62	67	2.3	2.1	1.9	1.8	1.6	1.4	1.2	1.1	.9	.8	.7
63	68	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	.9	.8	.7
64	69	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	.9	.8	.7
65	70	2.3	2.1	1.9	1.7	1.6	1.4	1.2	1.1	.9	.8	.7
66	71	2.3	2.1	1.9	1.7	1.5	1.4	1.2	1.1	.9	.8	.7
67	72	2.2	2.1	1.9	1.7	1.5	1.4	1.2	1.0	.9	.7	.7
68	73	2.2	2.0	1.9	1.7	1.5	1.4	1.2	1.0	.9	.7	.7
69	74	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	.9	.7	.6
70	75	2.2	2.0	1.8	1.7	1.5	1.3	1.2	1.0	.9	.7	.6
71	76	2.2	2.0	1.8	1.6	1.5	1.3	1.2	1.0	.9	.7	.6
72	77	2.1	2.0	1.8	1.6	1.5	1.3	1.1	1.0	.8	.7	.6
73	78	2.1	1.9	1.8	1.6	1.4	1.3	1.1	1.0	.8	.7	.6
74	79	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	.8	.7	.6
75	80	2.1	1.9	1.7	1.6	1.4	1.3	1.1	1.0	.8	.7	---
76	81	2.0	1.9	1.7	1.5	1.4	1.2	1.1	0.9	.8	.7	---
77	82	2.0	1.8	1.7	1.5	1.4	1.2	1.1	.9	.8	.7	---
78	83	2.0	1.8	1.6	1.5	1.3	1.2	1.0	.9	.8	.7	---
79	84	1.9	1.8	1.6	1.5	1.3	1.2	1.0	.9	.8	.7	---
80	85	1.9	1.7	1.6	1.4	1.3	1.1	1.0	.9	.7	.7	---
81	86	1.8	1.7	1.5	1.4	1.3	1.1	1.0	.8	.7	.6	---
82	87	1.8	1.7	1.5	1.4	1.2	1.1	1.0	.8	.7	.6	---
83	88	1.8	1.6	1.5	1.3	1.2	1.1	0.9	.8	.7	.6	---
84	89	1.7	1.6	1.4	1.3	1.2	1.0	.9	.8	.7	---	---

TABLE IIA.—ANNUITIES FOR JOINT LIFE ONLY—TWO LIVES—EXPECTED RETURN MULTIPLES—Continued

Ages											
	Male	87	88	89	90	91	92	93	94	95	96
Male	Female	92	93	94	95	96	97	98	99	100	101
85	90	3.1	2.9	2.8	2.7	2.6	2.5	2.3	2.2	2.1	1.9
86	91	3.0	2.8	2.7	2.6	2.5	2.4	2.3	2.1	2.0	1.9
87	92	2.9	2.8	2.6	2.5	2.4	2.3	2.2	2.1	1.9	1.8
88	93	2.8	2.7	2.6	2.4	2.3	2.2	2.1	2.0	1.9	1.7
89	94	2.6	2.6	2.5	2.4	2.2	2.1	2.0	1.9	1.8	1.7
90	95	2.5	2.4	2.4	2.3	2.2	2.0	1.9	1.8	1.7	1.6
91	96	2.4	2.3	2.2	2.2	2.1	2.0	1.9	1.7	1.6	1.5
92	97	2.3	2.2	2.1	2.0	2.0	1.9	1.8	1.7	1.6	1.5
93	98	2.2	2.1	2.0	1.9	1.9	1.8	1.7	1.6	1.5	1.4
94	99	2.1	2.0	1.9	1.8	1.7	1.7	1.6	1.5	1.4	1.3
95	100	1.9	1.9	1.8	1.7	1.6	1.6	1.5	1.4	1.3	1.2
96	101	1.8	1.7	1.7	1.6	1.5	1.5	1.4	1.3	1.2	1.1
97	102	1.7	1.6	1.6	1.5	1.4	1.4	1.3	1.2	1.1	1.1
98	103	1.6	1.5	1.4	1.4	1.3	1.3	1.2	1.1	1.0	1.0
99	104	1.4	1.4	1.3	1.3	1.2	1.1	1.1	1.0	1.0	.9
Ages											
	Male	97	98	99	100	101	102	103	104	105	106
Male	Female	102	103	104	105	106	107	108	109	110	111
85	90	1.8	1.7	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.7
86	91	1.7	1.6	1.5	1.3	1.2	1.1	1.0	.8	.7	.7
87	92	1.7	1.6	1.4	1.3	1.2	1.1	.9	.8	.7	.6
88	93	1.6	1.5	1.4	1.3	1.1	1.0	.9	.8	.7	.6
89	94	1.6	1.4	1.3	1.2	1.1	1.0	.9	.7	.7	----
90	95	1.5	1.4	1.3	1.2	1.0	.9	.8	.7	.6	----
91	96	1.4	1.3	1.2	1.1	1.0	.9	.8	.7	.6	----
92	97	1.4	1.3	1.1	1.0	.9	.8	.7	.7	----	----
93	98	1.3	1.2	1.1	1.0	.9	.8	.7	.6	----	----
94	99	1.2	1.1	1.0	.9	.8	.7	.7	----	----	----
95	100	1.1	1.0	1.0	.9	.8	.7	.6	----	----	----
96	101	1.1	1.0	.9	.8	.7	.7	----	----	----	----
97	102	1.0	.9	.8	.7	.7	.6	----	----	----	----
98	103	.9	.8	.7	.7	.6	----	----	----	----	----
99	104	.8	.7	.7	.6	----	----	----	----	----	----

Table III.—Percent Value of Refund Feature

Ages		Duration of guaranteed amount												
Male	Female	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years	9 years	10 years	11 years	12 years	13 years
		Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
6	11	--	--	--	--	--	--	--	--	1	1	1	1	1
7	12	--	--	--	--	--	--	--	--	1	1	1	1	1
8	13	--	--	--	--	--	--	--	1	1	1	1	1	1
9	14	--	--	--	--	--	--	--	1	1	1	1	1	1
10	15	--	--	--	--	--	--	--	1	1	1	1	1	1
11	16	--	--	--	--	--	--	--	1	1	1	1	1	1
12	17	--	--	--	--	--	--	--	1	1	1	1	1	1
13	18	--	--	--	--	--	--	--	1	1	1	1	1	1
14	19	--	--	--	--	--	--	--	1	1	1	1	1	1
15	20	--	--	--	--	--	--	--	1	1	1	1	1	1
16	21	--	--	--	--	--	--	--	1	1	1	1	1	1
17	22	--	--	--	--	--	--	--	1	1	1	1	1	1
18	23	--	--	--	--	--	--	--	1	1	1	1	1	1
19	24	--	--	--	--	--	--	--	1	1	1	1	1	1
20	25	--	--	--	--	--	--	--	1	1	1	1	1	1
21	26	--	--	--	--	--	--	--	1	1	1	1	1	1
22	27	--	--	--	--	--	--	1	1	1	1	1	1	1
23	28	--	--	--	--	--	--	1	1	1	1	1	1	1
24	29	--	--	--	--	--	--	1	1	1	1	1	1	1
25	30	--	--	--	--	--	--	1	1	1	1	1	1	1
26	31	--	--	--	--	--	1	1	1	1	1	1	1	1
27	32	--	--	--	--	--	1	1	1	1	1	1	1	1
28	33	--	--	--	--	--	1	1	1	1	1	1	1	1
29	34	--	--	--	--	--	1	1	1	1	1	1	1	2
30	35	--	--	--	--	1	1	1	1	1	1	1	2	2
31	36	--	--	--	--	1	1	1	1	1	1	1	2	2
32	37	--	--	--	--	1	1	1	1	1	1	2	2	2
33	38	--	--	--	1	1	1	1	1	1	1	2	2	2
34	39	--	--	--	1	1	1	1	1	1	2	2	2	2
35	40	--	--	--	1	1	1	1	1	2	2	2	2	2
36	41	--	--	--	1	1	1	1	1	2	2	2	2	3
37	42	--	--	1	1	1	1	1	2	2	2	2	3	3
38	43	--	--	1	1	1	1	1	2	2	2	2	3	3
39	44	--	--	1	1	1	1	2	2	2	2	3	3	3
40	45	--	--	1	1	1	1	2	2	2	3	3	3	4
41	46	--	--	1	1	1	1	2	2	2	3	3	3	4
42	47	--	--	1	1	1	2	2	2	3	3	3	4	4
43	48	--	1	1	1	1	2	2	2	3	3	4	4	4
44	49	--	1	1	1	1	2	2	3	3	3	4	4	5
45	50	--	1	1	1	2	2	2	3	3	4	4	5	5
46	51	--	1	1	1	2	2	3	3	3	4	4	5	5
47	52	--	1	1	1	2	2	3	3	4	4	5	5	6
48	53	--	1	1	2	2	2	3	3	4	5	5	6	6
49	54	--	1	1	2	2	3	3	4	4	5	5	6	7
50	55	--	1	1	2	2	3	3	4	5	5	6	7	7
51	56	--	1	1	2	3	3	4	4	5	6	6	7	8
52	57	1	1	2	2	3	3	4	5	5	6	7	8	8
53	58	1	1	2	2	3	4	4	5	6	7	7	8	9
54	59	1	1	2	2	3	4	5	5	6	7	8	9	10
55	60	1	1	2	3	3	4	5	6	7	8	8	9	10
56	61	1	1	2	3	4	4	5	6	7	8	9	10	11
57	62	1	1	2	3	4	5	6	7	8	9	10	11	12
58	63	1	2	2	3	4	5	6	7	8	9	10	12	13
59	64	1	2	3	4	5	6	7	8	9	10	11	12	14
60	65	1	2	3	4	5	6	7	8	10	11	12	13	15
61	66	1	2	3	4	5	6	8	9	10	12	13	14	16
62	67	1	2	3	4	6	7	8	10	11	12	14	15	17
63	68	1	2	4	5	6	7	9	10	12	13	15	16	18
64	69	1	3	4	5	7	8	9	11	13	14	16	17	19
65	70	1	3	4	6	7	9	10	12	13	15	17	19	20

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount												
Male	Female	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years	9 years	10 years	11 years	12 years	13 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
66	71	1	3	4	6	8	9	11	13	14	16	18	20	22
67	72	2	3	5	6	8	10	12	14	15	17	19	21	23
68	73	2	3	5	7	9	11	13	14	16	18	21	23	25
69	74	2	4	6	7	9	11	13	16	18	20	22	24	26
70	75	2	4	6	8	10	12	14	17	19	21	23	26	28
71	76	2	4	6	9	11	13	15	18	20	22	25	27	29
72	77	2	5	7	9	12	14	16	19	21	24	26	29	31
73	78	2	5	7	10	12	15	18	20	23	25	28	30	33
74	79	3	5	8	11	13	16	19	22	24	27	30	32	35
75	80	3	6	8	11	14	17	20	23	26	29	31	34	37
76	81	3	6	9	12	15	18	21	24	27	30	33	36	39
77	82	3	7	10	13	16	20	23	26	29	32	35	38	41
78	83	4	7	11	14	17	21	24	28	31	34	37	40	43
79	84	4	8	11	15	19	22	26	29	33	36	39	42	45
80	85	4	8	12	16	20	24	27	31	34	38	41	44	47
81	86	4	9	13	17	21	25	29	33	36	40	43	46	49
82	87	5	9	14	18	23	27	31	35	38	42	45	48	51
83	88	5	10	15	19	24	28	33	37	40	44	47	50	53
84	89	5	11	16	21	26	30	34	38	42	46	49	52	55
85	90	6	11	17	22	27	32	36	41	44	48	51	55	57

Ages		Duration of guaranteed amount												
Male	Female	14 years	15 years	16 years	17 years	18 years	19 years	20 years	21 years	22 years	23 years	24 years	25 years	26 years
		Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent	Percent
6	11	1	1	1	1	1	1	1	1	1	1	2	2	2
7	12	1	1	1	1	1	1	1	1	1	1	2	2	2
8	13	1	1	1	1	1	1	1	1	1	1	2	2	2
9	14	1	1	1	1	1	1	1	1	1	1	2	2	2
10	15	1	1	1	1	1	1	1	1	1	2	2	2	2
11	16	1	1	1	1	1	1	1	1	1	2	2	2	2
12	17	1	1	1	1	1	1	1	1	1	2	2	2	2
13	18	1	1	1	1	1	1	1	1	2	2	2	2	2
14	19	1	1	1	1	1	1	1	1	2	2	2	2	2
15	20	1	1	1	1	1	1	1	1	2	2	2	2	2
16	21	1	1	1	1	1	1	1	2	2	2	2	2	2
17	22	1	1	1	1	1	1	1	2	2	2	2	2	2
18	23	1	1	1	1	1	1	2	2	2	2	2	2	2
19	24	1	1	1	1	1	2	2	2	2	2	2	2	2
20	25	1	1	1	1	1	2	2	2	2	2	2	2	3
21	26	1	1	1	1	2	2	2	2	2	2	2	3	3
22	27	1	1	1	1	2	2	2	2	2	2	3	3	3
23	28	1	1	1	2	2	2	2	2	2	2	3	3	3
24	29	1	1	2	2	2	2	2	2	2	3	3	3	3
25	30	1	1	2	2	2	2	2	2	3	3	3	3	3
26	31	1	2	2	2	2	2	2	3	3	3	3	3	4
27	32	2	2	2	2	2	2	3	3	3	3	3	4	4
28	33	2	2	2	2	2	3	3	3	3	3	4	4	4
29	34	2	2	2	2	2	3	3	3	3	4	4	4	5
30	35	2	2	2	2	3	3	3	3	4	4	4	5	5
31	36	2	2	2	3	3	3	3	4	4	4	5	5	5
32	37	2	2	3	3	3	3	4	4	4	5	5	5	6
33	38	2	3	3	3	3	4	4	4	5	5	5	6	6
34	39	3	3	3	3	4	4	4	5	5	5	6	6	7
35	40	3	3	3	4	4	4	5	5	5	6	6	7	7

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount												
Male	Female	14 years	15 years	16 years	17 years	18 years	19 years	20 years	21 years	22 years	23 years	24 years	25 years	26 years
		Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
36	41	3	3	4	4	4	5	5	5	6	6	7	7	8
37	42	3	3	4	4	4	5	5	6	6	7	7	8	8
38	43	3	4	4	4	5	5	6	6	7	7	8	8	9
39	44	4	4	4	5	5	6	6	7	7	8	8	9	9
40	45	4	4	5	5	6	6	7	7	8	8	9	9	10
41	46	4	5	5	6	6	7	7	8	8	9	9	10	11
42	47	5	5	5	6	6	7	8	8	9	9	10	11	12
43	48	5	5	6	6	7	8	8	9	9	10	11	12	12
44	49	5	6	6	7	7	8	9	9	10	11	12	12	13
45	50	6	6	7	7	8	9	9	10	11	12	12	13	14
46	51	6	7	7	8	9	9	10	11	12	12	13	14	15
47	52	7	7	8	9	9	10	11	12	12	13	14	15	16
48	53	7	8	8	9	10	11	12	12	13	14	15	16	17
49	54	8	8	9	10	11	11	12	13	14	15	16	17	18
50	55	8	9	10	11	11	12	13	14	15	16	17	18	20
51	56	9	10*	10	11	12	13	14	15	16	17	18	20	21
52	57	9	10	11	12	13	14	15	16	17	18	20	21	22
53	58	10	11	12	13	14	15	16	17	19	20	21	22	24
54	59	11	12	13	14	15	16	17	18	20	21	22	24	25
55	60	11	13	14	15	16	17	18	20	21	22	24	25	26
56	61	12	13	15	16	17	18	20	21	22	24	25	27	28
57	62	13	14	16	17	18	20	21	22	24	25	27	28	30
58	63	14	15	17	18	19	21	22	24	25	27	28	30	31
59	64	15	16	18	19	21	22	24	25	27	28	30	31	33
60	65	16	18	19	20	22	24	25	27	28	30	32	33	35
61	66	17	19	20	22	23	25	27	28	30	32	33	35	37
62	67	18	20	22	23	25	27	28	30	32	33	35	37	38
63	68	20	21	23	25	26	28	30	32	33	35	37	39	40
64	69	21	23	24	26	28	30	32	33	35	37	39	41	42
65	70	22	24	26	28	30	32	33	35	37	39	41	42	44
66	71	24	26	28	29	31	33	35	37	39	41	43	44	46
67	72	25	27	29	31	33	35	37	39	41	43	45	46	48
68	73	27	29	31	33	35	37	39	41	43	45	47	48	50
69	74	28	30	33	35	37	39	41	43	45	47	48	50	52
70	75	30	32	34	37	39	41	43	45	47	49	50	52	54
71	76	32	34	36	39	41	43	45	47	49	51	52	54	56
72	77	34	36	38	41	43	45	47	49	51	53	54	56	58
73	78	35	38	40	43	45	47	49	51	53	55	56	58	59
74	79	37	40	42	45	47	49	51	53	55	57	58	60	61
75	80	39	42	44	47	49	51	53	55	57	58	60	62	63
76	81	41	44	46	49	51	53	55	57	59	60	62	63	65
77	82	43	46	48	51	53	55	57	59	61	62	64	65	66
78	83	45	48	50	53	55	57	59	61	62	64	65	67	68
79	84	48	50	53	55	57	59	61	63	64	66	67	68	70
80	85	50	52	55	57	59	61	63	64	66	67	69	70	71
81	86	52	54	57	59	61	63	65	66	68	69	70	72	73
82	87	54	56	59	61	63	65	66	68	69	71	72	73	74
83	88	56	58	61	63	65	66	68	70	71	72	73	74	75
84	89	58	60	63	65	67	68	70	71	73	74	75	76	77
85	90	60	62	65	67	68	70	71	73	74	75	76	77	---

*Erroneously shown as 9 in T. D. 6211; corrected by T. D. 6233.

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages		Duration of guaranteed amount								
Male	Female	27 years	28 years	29 years	30 years	31 years	32 years	33 years	34 years	35 years
		Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
6	11	2	2	2	2	2	2	2	2	2
7	12	2	2	2	2	2	2	2	2	3
8	13	2	2	2	2	2	2	2	2	3
9	14	2	2	2	2	2	2	2	3	3
10	15	2	2	2	2	2	2	3	3	3
11	16	2	2	2	2	2	2	3	3	3
12	17	2	2	2	2	2	3	3	3	3
13	18	2	2	2	2	2	3	3	3	3
14	19	2	2	2	2	3	3	3	3	3
15	20	2	2	2	3	3	3	3	3	3
16	21	2	2	3	3	3	3	3	3	4
17	22	2	2	3	3	3	3	3	4	4
18	23	2	3	3	3	3	3	4	4	4
19	24	3	3	3	3	3	4	4	4	4
20	25	3	3	3	3	4	4	4	4	5
21	26	3	3	3	4	4	4	4	5	5
22	27	3	3	4	4	4	4	5	5	5
23	28	3	3	4	4	4	5	5	5	5
24	29	3	4	4	4	5	5	5	5	6
25	30	4	4	4	5	5	5	6	6	6
26	31	4	4	5	5	5	6	6	6	7
27	32	4	5	5	5	6	6	6	7	7
28	33	5	5	5	6	6	6	7	7	8
29	34	5	5	6	6	6	7	7	8	8
30	35	5	6	6	6	7	7	8	8	9
31	36	6	6	6	7	7	8	8	9	9
32	37	6	7	7	7	8	8	9	10	10
33	38	7	7	7	8	8	9	10	10	11
34	39	7	8	8	9	9	10	10	11	12
35	40	8	8	9	9	10	10	11	12	12
36	41	8	9	9	10	10	11	12	13	13
37	42	9	9	10	11	11	12	13	13	14
38	43	9	10	11	11	12	13	13	14	15
39	44	10	11	11	12	13	14	14	15	16
40	45	11	11	12	13	14	15	15	16	17
41	46	11	12	13	14	15	16	16	17	18
42	47	12	13	14	15	16	17	18	18	19
43	48	13	14	15	16	17	18	19	20	21
44	49	14	15	16	17	18	19	20	21	22
45	50	15	16	17	18	19	20	21	22	23
46	51	16	17	18	19	20	21	22	24	25
47	52	17	18	19	20	21	23	24	25	26
48	53	18	19	20	22	23	24	25	26	28
49	54	19	21	22	23	24	25	27	28	29
50	55	21	22	23	24	26	27	28	29	31
51	56	22	23	25	26	27	28	30	31	32
52	57	23	25	26	27	29	30	31	33	34
53	58	25	26	28	29	30	32	33	34	36
54	59	26	28	29	31	32	33	35	36	38
55	60	28	29	31	32	34	35	36	38	39
56	61	29	31	32	34	35	37	38	40	41
57	62	31	33	34	36	37	39	40	41	43
58	63	33	34	36	37	39	40	42	43	45
59	64	35	36	38	39	41	42	44	45	47
60	65	36	38	40	41	43	44	46	47	48
61	66	38	40	41	43	44	46	47	49	50
62	67	40	42	43	45	46	48	49	51	52
63	68	42	44	45	47	48	50	51	52	54
64	69	44	46	47	49	50	52	53	54	55
65	70	46	47	49	50	52	53	55	56	57
66	71	48	49	51	52	54	55	56	58	59
67	72	50	51	53	54	56	57	58	59	61
68	73	52	53	55	56	57	59	60	61	62
69	74	53	55	56	58	59	60	62	63	64
70	75	55	57	58	60	61	62	63	64	65

TABLE III.—PERCENT VALUE OF REFUND FEATURE—Continued

Ages: Male	Ages: Female	Duration of guaranteed amount: 27 years	28 years	29 years	30 years	31 years	32 years	33 years	34 years	35 years
		Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
71	76	57	59	60	61	63	64	65	66	67
72	77	59	60	62	63	64	65	66	67	68
73	78	61	62	64	65	66	67	68	69	70
74	79	63	64	65	66	67	68	69	70	71
75	80	64	66	67	68	69	70	71	72	72
76	81	66	67	68	69	70	71	72	73	----
77	82	68	69	70	71	72	73	74	----	----
78	83	69	70	71	72	73	74	----	----	----
79	84	71	72	73	74	75	----	----	----	----
80	85	72	73	74	75	----	----	----	----	----
81	86	74	75	75	-----	----	----	----	----	----
82	87	75	76	-----	-----	----	----	----	----	----
83	88	76	-----	-----	-----	----	----	----	----	----
84	89	-----	-----	-----	-----	----	----	----	----	----
85	90	-----	-----	-----	-----	----	----	----	----	----

Ages: Male	Ages: Female	Duration of guaranteed amount: 1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years	9 years	10 years	11 years	12 years	13 years	14 years
		Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
86	91	6	12	18	24	29	34	38	43	47	50	54	57	59	62
87	92	7	13	19	25	31	36	40	45	49	52	56	59	61	64
88	93	7	14	21	27	32	38	42	47	51	55	58	61	63	66
89	94	8	15	22	28	34	40	45	49	53	57	60	63	65	68
90	95	8	16	23	30	36	42	47	51	55	59	62	65	67	70
91	96	9	17	25	32	38	44	49	53	57	61	64	67	69	71
92	97	9	18	26	34	40	46	51	55	59	63	66	69	71	73
93	98	10	20	28	36	42	48	53	58	62	65	68	70	73	75
94	99	11	21	30	37	44	50	55	60	64	67	70	72	74	76
95	100	12	22	31	39	46	52	58	62	66	69	72	74	76	78
96	101	12	24	33	42	49	55	60	64	68	71	73	76	78	79
97	102	13	25	35	44	51	57	62	66	70	73	75	77	79	--
98	103	14	27	37	46	54	60	65	69	72	75	77	79	--	--
99	104	15	29	40	49	56	62	67	71	74	77	79	--	--	--
100	105	17	31	43	52	59	65	70	74	76	79	--	--	--	--
101	106	18	33	46	55	63	68	73	76	79	--	--	--	--	--
102	107	20	36	49	59	66	71	75	78	--	--	--	--	--	--
103	108	22	40	53	62	69	74	78	--	--	--	--	--	--	--
104	109	24	43	57	66	73	77	--	--	--	--	--	--	--	--
105	110	27	48	61	70	76	--	--	--	--	--	--	--	--	--
106	111	31	53	66	74	--	--	--	--	--	--	--	--	--	--
107	112	35	58	71	--	--	--	--	--	--	--	--	--	--	--
108	113	40	64	--	--	--	--	--	--	--	--	--	--	--	--

Ages: Male	Ages: Female	Duration of guaranteed amount: 15 years	16 years	17 years	18 years	19 years	20 years	21 years	22 years	23 years	24 years	25 years
		Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
86	91	64	66	68	70	72	73	74	75	76	77	---
87	92	66	68	70	72	73	74	76	77	78	---	---
88	93	68	70	72	73	75	76	77	78	---	---	---
89	94	70	72	73	75	76	77	78	---	---	---	---
90	95	72	73	75	76	77	79	---	---	---	---	---
91	96	73	75	76	78	79	---	---	---	---	---	---
92	97	75	76	78	79	---	---	---	---	---	---	---
93	98	76	78	79	---	---	---	---	---	---	---	---
94	99	78	79	---	---	---	---	---	---	---	---	---
95	100	79	---	---	---	---	---	---	---	---	---	---

§ 1.72–9

TABLE IV.—TEMPORARY LIFE ANNUITIES[1]—ONE LIFE—EXPECTED RETURN MULTIPLES

Ages		Temporary period—maximum duration of annuity									
Male	Female	Years									
		1	2	3	4	5	6	7	8	9	10
0 to 8	0 to 13	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
9	14	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
10	15	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
11	16	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
12	17	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
13	18	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
14	19	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
15	20	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
16	21	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
17	22	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
18	23	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
19	24	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
20	25	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
21	26	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
22	27	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
23	28	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	8.9	9.9
24	29	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
25	30	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
26	31	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
27	32	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
28	33	1.0	2.0	3.0	4.0	5.0	6.0	7.0	7.9	8.9	9.9
29	34	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
30	35	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
31	36	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
32	37	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
33	38	1.0	2.0	3.0	4.0	5.0	6.0	6.9	7.9	8.9	9.9
34	39	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
35	40	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
36	41	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.9	9.8
37	42	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
38	43	1.0	2.0	3.0	4.0	5.0	5.9	6.9	7.9	8.8	9.8
39	44	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.9	8.8	9.8
40	45	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
41	46	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
42	47	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
43	48	1.0	2.0	3.0	4.0	4.9	5.9	6.9	7.8	8.8	9.7
44	49	1.0	2.0	3.0	4.0	4.9	5.9	6.8	7.8	8.7	9.7
45	50	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
46	51	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.8	8.7	9.6
47	52	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.7	9.6
48	53	1.0	2.0	3.0	3.9	4.9	5.9	6.8	7.7	8.6	9.5
49	54	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
50	55	1.0	2.0	3.0	3.9	4.9	5.8	6.8	7.7	8.6	9.5
51	56	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.7	8.6	9.4
52	57	1.0	2.0	3.0	3.9	4.9	5.8	6.7	7.6	8.5	9.4
53	58	1.0	2.0	2.9	3.9	4.9	5.8	6.7	7.6	8.5	9.3
54	59	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.6	8.4	9.3
55	60	1.0	2.0	2.9	3.9	4.8	5.8	6.7	7.5	8.4	9.2
56	61	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.4	9.2
57	62	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.5	8.3	9.1
58	63	1.0	2.0	2.9	3.9	4.8	5.7	6.6	7.4	8.3	9.1
59	64	1.0	2.0	2.9	3.9	4.8	5.7	6.5	7.4	8.2	9.0
60	65	1.0	2.0	2.9	3.8	4.8	5.6	6.5	7.3	8.1	8.9
61	66	1.0	2.0	2.9	3.8	4.7	5.6	6.5	7.3	8.1	8.8
62	67	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	8.0	8.8
63	68	1.0	2.0	2.9	3.8	4.7	5.6	6.4	7.2	7.9	8.7
64	69	1.0	1.9	2.9	3.8	4.7	5.5	6.3	7.1	7.9	8.6
65	70	1.0	1.9	2.9	3.8	4.6	5.5	6.3	7.1	7.8	8.5
66	71	1.0	1.9	2.9	3.8	4.6	5.4	6.2	7.0	7.7	8.4
67	72	1.0	1.9	2.9	3.7	4.6	5.4	6.2	6.9	7.6	8.3
68	73	1.0	1.9	2.8	3.7	4.6	5.4	6.1	6.8	7.5	8.2
69	74	1.0	1.9	2.8	3.7	4.5	5.3	6.1	6.8	7.4	8.0
70	75	1.0	1.9	2.8	3.7	4.5	5.3	6.0	6.7	7.3	7.9
71	76	1.0	1.9	2.8	3.7	4.5	5.2	5.9	6.6	7.2	7.8
72	77	1.0	1.9	2.8	3.6	4.4	5.2	5.8	6.5	7.1	7.6
73	78	1.0	1.9	2.8	3.6	4.4	5.1	5.8	6.4	7.0	7.5
74	79	1.0	1.9	2.8	3.6	4.3	5.0	5.7	6.3	6.8	7.3
75	80	1.0	1.9	2.7	3.5	4.3	5.0	5.6	6.2	6.7	7.1
76	81	1.0	1.9	2.7	3.5	4.2	4.9	5.5	6.1	6.5	7.0
77	82	1.0	1.9	2.7	3.5	4.2	4.8	5.4	5.9	6.4	6.8
78	83	1.0	1.9	2.7	3.4	4.1	4.7	5.3	5.8	6.2	6.6
79	84	1.0	1.8	2.7	3.4	4.1	4.7	5.2	5.7	6.1	6.4
80	85	1.0	1.8	2.6	3.4	4.0	4.6	5.1	5.5	5.9	6.2
81	86	1.0	1.8	2.6	3.3	3.9	4.5	5.0	5.4	5.7	6.0
82	87	1.0	1.8	2.6	3.3	3.9	4.4	4.8	5.2	5.6	5.8
83	88	.9	1.8	2.6	3.2	3.8	4.3	4.7	5.1	5.4	5.6
84	89	.9	1.8	2.5	3.2	3.7	4.2	4.6	4.9	5.2	5.4
85	90	.9	1.8	2.5	3.1	3.6	4.1	4.5	4.8	5.0	5.2
86	91	.9	1.8	2.5	3.1	3.6	4.0	4.3	4.6	4.8	5.0

[1] See footnote at end of table.

TABLE IV.—TEMPORARY LIFE ANNUITIES[1]—ONE LIFE—EXPECTED RETURN MULTIPLES—Continued

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	11	12	13	14	15	16	17	18	19	20
0 to 8	0 to 13	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
9	14	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
10	15	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
11	16	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
12	17	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
13	18	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
14	19	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.8	19.7
15	20	10.9	11.9	12.9	13.9	14.9	15.8	16.8	17.8	18.7	19.7
16	21	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
17	22	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
18	23	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.8	18.7	19.7
19	24	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
20	25	10.9	11.9	12.9	13.9	14.8	15.8	16.8	17.7	18.7	19.7
21	26	10.9	11.9	12.9	13.8	14.8	15.8	16.8	17.7	18.7	19.6
22	27	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
23	28	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.7	19.6
24	29	10.9	11.9	12.9	13.8	14.8	15.8	16.7	17.7	18.6	19.6
25	30	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.7	18.6	19.6
26	31	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
27	32	10.9	11.9	12.8	13.8	14.8	15.7	16.7	17.6	18.6	19.5
28	33	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.5
29	34	10.9	11.8	12.8	13.8	14.7	15.7	16.6	17.6	18.5	19.4
30	35	10.9	11.8	12.8	13.7	14.7	15.6	16.6	17.5	18.4	19.4
31	36	10.8	11.8	12.8	13.7	14.7	15.6	16.5	17.5	18.4	19.3
32	37	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.4	19.3
33	38	10.8	11.8	12.7	13.7	14.6	15.6	16.5	17.4	18.3	19.2
34	39	10.8	11.8	12.7	13.6	14.6	15.5	16.4	17.4	18.3	19.2
35	40	10.8	11.7	12.7	13.6	14.6	15.5	16.4	17.3	18.2	19.1
36	41	10.8	11.7	12.7	13.6	14.5	15.4	16.3	17.2	18.1	19.0
37	42	10.8	11.7	12.6	13.6	14.5	15.4	16.3	17.2	18.1	18.9
38	43	10.7	11.7	12.6	13.5	14.4	15.3	16.2	17.1	18.0	18.9
39	44	10.7	11.6	12.6	13.5	14.4	15.3	16.2	17.1	17.9	18.8
40	45	10.7	11.6	12.5	13.5	14.4	15.2	16.1	17.0	17.8	18.7
41	46	10.7	11.6	12.5	13.4	14.3	15.2	16.1	16.9	17.8	18.6
42	47	10.6	11.6	12.5	13.4	14.3	15.1	16.0	16.8	17.7	18.5
43	48	10.6	11.5	12.4	13.3	14.2	15.1	15.9	16.7	17.6	18.4
44	49	10.6	11.5	12.4	13.3	14.1	15.0	15.8	16.7	17.5	18.3
45	50	10.5	11.4	12.3	13.2	14.1	14.9	15.7	16.6	17.4	18.1
46	51	10.5	11.4	12.3	13.2	14.0	14.8	15.7	16.5	17.2	18.0
47	52	10.5	11.4	12.2	13.1	13.9	14.7	15.6	16.3	17.1	17.8
48	53	10.4	11.3	12.2	13.0	13.8	14.7	15.4	16.2	17.0	17.7
49	54	10.4	11.3	12.1	12.9	13.8	14.6	15.3	16.1	16.8	17.5
50	55	10.3	11.2	12.0	12.9	13.7	14.5	15.2	16.0	16.7	17.4
51	56	10.3	11.1	12.0	12.8	13.6	14.3	15.1	15.8	16.5	17.2
52	57	10.2	11.1	11.9	12.7	13.5	14.2	14.9	15.6	16.3	17.0
53	58	10.2	11.0	11.8	12.6	13.4	14.1	14.8	15.5	16.1	16.8
54	59	10.1	10.9	11.7	12.5	13.2	14.0	14.6	15.3	15.9	16.5
55	60	10.1	10.9	11.6	12.4	13.1	13.8	14.5	15.1	15.7	16.3
56	61	10.0	10.8	11.5	12.3	13.0	13.7	14.3	14.9	15.5	16.1
57	62	9.9	10.7	11.4	12.2	12.8	13.5	14.1	14.7	15.3	15.8
58	63	9.8	10.6	11.3	12.0	12.7	13.3	13.9	14.5	15.0	15.5
59	64	9.8	10.5	11.2	11.9	12.5	13.2	13.7	14.3	14.8	15.3
60	65	9.7	10.4	11.1	11.7	12.4	13.0	13.5	14.0	14.5	15.0
61	66	9.6	10.3	11.0	11.6	12.2	12.8	13.3	13.8	14.2	14.7
62	67	9.5	10.2	10.8	11.4	12.0	12.5	13.1	13.5	14.0	14.3
63	68	9.4	10.0	10.7	11.3	11.8	12.3	12.8	13.2	13.7	14.0
64	69	9.3	9.9	10.5	11.1	11.6	12.1	12.5	13.0	13.3	13.7
65	70	9.1	9.8	10.3	10.9	11.4	11.9	12.3	12.7	13.0	13.3
66	71	9.0	9.6	10.2	10.7	11.2	11.6	12.0	12.4	12.7	13.0
67	72	8.9	9.5	10.0	10.5	10.9	11.3	11.7	12.0	12.3	12.6
68	73	8.7	9.3	9.8	10.3	10.7	11.1	11.4	11.7	12.0	12.2
69	74	8.6	9.1	9.6	10.0	10.4	10.8	11.1	11.4	11.6	11.8
70	75	8.4	8.9	9.4	9.8	10.2	10.5	10.8	11.0	11.2	11.4
71	76	8.3	8.7	9.2	9.6	9.9	10.2	10.4	10.7	10.9	11.0
72	77	8.1	8.6	8.9	9.3	9.6	9.9	10.1	10.3	10.5	10.6
73	78	7.9	8.3	8.7	9.0	9.3	9.6	9.8	9.9	10.1	10.2
74	79	7.7	8.1	8.5	8.8	9.0	9.2	9.4	9.6	9.7	9.8
75	80	7.6	7.9	8.2	8.5	8.7	8.9	9.1	9.2	9.3	9.4
76	81	7.4	7.7	8.0	8.2	8.4	8.6	8.7	8.8	8.9	9.0
77	82	7.1	7.5	7.7	7.9	8.1	8.3	8.4	8.5	8.5	8.6
78	83	6.9	7.2	7.4	7.6	7.8	7.9	8.0	8.1	8.2	8.2
79	84	6.7	7.0	7.2	7.3	7.5	7.6	7.7	7.7	7.8	7.8
80	85	6.5	6.7	6.9	7.1	7.2	7.3	7.3	7.4	7.4	7.4
81	86	6.3	6.5	6.6	6.8	6.9	6.9	7.0	7.0	7.1	----
82	87	6.0	6.2	6.4	6.5	6.5	6.6	6.7	6.7	----	----
83	88	5.8	6.0	6.1	6.2	6.2	6.3	6.3	----	----	----
84	89	5.6	5.7	5.8	5.9	5.9	6.0	----	----	----	----
85	90	5.3	5.5	5.5	5.6	5.6	----	----	----	----	----
86	91	5.1	5.2	5.3	5.3	----	----	----	----	----	----

[1] See footnote at end of table.

§ 1.72-9

Table IV.—Temporary Life Annuities[1]—One Life—Expected Return Multiples—Continued

Ages		Temporary period—maximum duration of annuity									
		Years									
Male	Female	21	22	23	24	25	26	27	28	29	30
0 to 8	0 to 13	20.7	21.7	22.7	23.6	24.6	25.6	26.5	27.5	28.4	29.4
9	14	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
10	15	20.7	21.7	22.7	23.6	24.6	25.5	26.5	27.5	28.4	29.4
11	16	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
12	17	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
13	18	20.7	21.7	22.6	23.6	24.6	25.5	26.5	27.4	28.4	29.3
14	19	20.7	21.7	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.3
15	20	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.4	28.3	29.2
16	21	20.7	21.6	22.6	23.6	24.5	25.5	26.4	27.3	28.3	29.2
17	22	20.7	21.6	22.6	23.5	24.5	25.4	26.4	27.3	28.2	29.2
18	23	20.7	21.6	22.6	23.5	24.5	25.4	26.3	27.3	28.2	29.1
19	24	20.6	21.6	22.5	23.5	24.4	25.4	26.3	27.2	28.1	29.1
20	25	20.6	21.6	22.5	23.5	24.4	25.3	26.3	27.2	28.1	29.0
21	26	20.6	21.5	22.5	23.4	24.4	25.3	26.2	27.1	28.0	28.9
22	27	20.6	21.5	22.5	23.4	24.3	25.3	26.2	27.1	28.0	28.9
23	28	20.6	21.5	22.4	23.4	24.3	25.2	26.1	27.0	27.9	28.8
24	29	20.5	21.5	22.4	23.3	24.2	25.2	26.1	27.0	27.8	28.7
25	30	20.5	21.4	22.4	23.3	24.2	25.1	26.0	26.9	27.8	28.6
26	31	20.5	21.4	22.3	23.2	24.1	25.0	25.9	26.8	27.7	28.5
27	32	20.4	21.3	22.3	23.2	24.1	25.0	25.8	26.7	27.6	28.4
28	33	20.4	21.3	22.2	23.1	24.0	24.9	25.8	26.6	27.5	28.3
29	34	20.3	21.2	22.1	23.0	23.9	24.8	25.7	26.5	27.4	28.2
30	35	20.3	21.2	22.1	23.0	23.8	24.7	25.6	26.4	27.2	28.1
31	36	20.2	21.1	22.0	22.9	23.8	24.6	25.5	26.3	27.1	27.9
32	37	20.2	21.1	21.9	22.8	23.7	24.5	25.4	26.2	27.0	27.8
33	38	20.1	21.0	21.9	22.7	23.6	24.4	25.2	26.0	26.8	27.6
34	39	20.0	20.9	21.8	22.6	23.5	24.3	25.1	25.9	26.7	27.4
35	40	20.0	20.8	21.7	22.5	23.3	24.2	25.0	25.7	26.5	27.2
36	41	19.9	20.7	21.6	22.4	23.2	24.0	24.8	25.6	26.3	27.0
37	42	19.8	20.6	21.5	22.3	23.1	23.9	24.6	25.4	26.1	26.8
38	43	19.7	20.5	21.4	22.2	23.0	23.7	24.5	25.2	25.9	26.6
39	44	19.6	20.4	21.2	22.0	22.8	23.6	24.3	25.0	25.7	26.4
40	45	19.5	20.3	21.1	21.9	22.6	23.4	24.1	24.8	25.5	26.1
41	46	19.4	20.2	21.0	21.7	22.5	23.2	23.9	24.6	25.2	25.9
42	47	19.3	20.1	20.8	21.6	22.3	23.0	23.7	24.3	25.0	25.6
43	48	19.2	19.9	20.7	21.4	22.1	22.8	23.4	24.1	24.7	25.3
44	49	19.0	19.8	20.5	21.2	21.9	22.6	23.2	23.8	24.4	25.0
45	50	18.9	19.6	20.3	21.0	21.7	22.3	22.9	23.5	24.1	24.6
46	51	18.7	19.4	20.1	20.8	21.5	22.1	22.7	23.2	23.8	24.3
47	52	18.6	19.3	19.9	20.6	21.2	21.8	22.4	22.9	23.4	23.9
48	53	18.4	19.1	19.7	20.4	21.0	21.5	22.1	22.6	23.1	23.5
49	54	18.2	18.9	19.5	20.1	20.7	21.2	21.7	22.2	22.7	23.1
50	55	18.0	18.7	19.3	19.8	20.4	20.9	21.4	21.9	22.3	22.7
51	56	17.8	18.4	19.0	19.6	20.1	20.6	21.1	21.5	21.9	22.3
52	57	17.6	18.2	18.7	19.3	19.8	20.2	20.7	21.1	21.5	21.8
53	58	17.4	17.9	18.5	19.0	19.4	19.9	20.3	20.7	21.0	21.3
54	59	17.1	17.7	18.2	18.7	19.1	19.5	19.9	20.2	20.6	20.8
55	60	16.9	17.4	17.9	18.3	18.7	19.1	19.5	19.8	20.1	20.3
56	61	16.6	17.1	17.5	18.0	18.4	18.7	19.0	19.3	19.6	19.8
57	62	16.3	16.8	17.2	17.6	18.0	18.3	18.6	18.9	19.1	19.3
58	63	16.0	16.5	16.9	17.2	17.6	17.9	18.1	18.4	18.6	18.8
59	64	15.7	16.1	16.5	16.8	17.1	17.4	17.7	17.9	18.1	18.2
60	65	15.4	15.8	16.1	16.4	16.7	17.0	17.2	17.4	17.5	17.7
61	66	15.1	15.4	15.7	16.0	16.3	16.5	16.7	16.9	17.0	17.1
62	67	14.7	15.0	15.3	15.6	15.8	16.0	16.2	16.3	16.4	16.5
63	68	14.4	14.6	14.9	15.1	15.3	15.5	15.7	15.8	15.9	16.0
64	69	14.0	14.3	14.5	14.7	14.9	15.0	15.2	15.3	15.3	15.4
65	70	13.6	13.8	14.1	14.2	14.4	14.5	14.6	14.7	14.8	14.9
66	71	13.2	13.4	13.6	13.8	13.9	14.0	14.1	14.2	14.2	14.3
67	72	12.8	13.0	13.2	13.3	13.4	13.5	13.6	13.7	13.7	13.7
68	73	12.4	12.6	12.7	12.8	12.9	13.0	13.1	13.1	13.2	13.2
69	74	12.0	12.1	12.3	12.4	12.4	12.5	12.6	12.6	12.6	12.6
70	75	11.6	11.7	11.8	11.9	12.0	12.0	12.0	12.1	12.1	12.1
71	76	11.2	11.3	11.3	11.4	11.5	11.5	11.5	11.6	11.6	----
72	77	10.7	10.8	10.9	10.9	11.0	11.0	11.0	11.0	----	----
73	78	10.3	10.4	10.4	10.5	10.5	10.5	10.5	----	----	----
74	79	9.9	9.9	10.0	10.0	10.1	10.1	----	----	----	----
75	80	9.5	9.5	9.6	9.6	9.6	----	----	----	----	----
76	81	9.1	9.1	9.1	9.1	----	----	----	----	----	----
77	82	8.6	8.7	8.7	---	----	----	----	----	----	----
78	83	8.2	8.3	---	---	----	----	----	----	----	----
79	84	7.8	---	---	---	----	----	----	----	----	----

[1] The multiples in this table are not applicable to annuities for a term certain; for such cases, see § 1.72-5(c).

If the terms of the contract (a) involve a life or lives, (b) are such that the above tables cannot be correctly applied, and (c) the amounts received thereunder are at least partly "amounts received as an annuity" under a contract to which section 72 applies, the taxpayer may submit with his return an actuarial computation based upon the 1937 Standard Annuity Table with ages set back one year, showing the appropriate factors applied in his case, subject to the approval of the Commissioner upon examination of such return. Computations involving factors to compensate for the effects of contingencies other than mortality, such as marriage or remarriage, re-employment, recovery from disability, or the like, will not be approved.

§ 1.72–10 EFFECT OF TRANSFER OF CONTRACTS ON INVESTMENT IN THE CONTRACT.—(a) If a contract to which section 72 applies, or any interest therein, is transferred for a valuable consideration, by assignment or otherwise, only the actual value of the consideration given for such transfer and the amount of premiums or other consideration subsequently paid by the transferee shall be included in the transferee's aggregate of premiums or other consideration paid. In accordance with the provisions of section 72(g)(3) and paragraph (b) of § 1.72–4, an annuity starting date shall be determined for the transferee without regard to the annuity starting date, if any, of the transferor. In determining the transferee's investment in the contract, the aggregate amount of premiums or other consideration paid shall be reduced by all amounts received by the transferee before the receipt of an amount as an annuity or before the annuity starting date, whichever is the later, to the extent that such amounts were excludable from his gross income under the applicable income tax law at the time of receipt. For the treatment of amounts received by the transferee subsequent to both the annuity starting date and the date of receipt of a payment as an annuity, but not received as annuity payments, see § 1.72–11. For a limitation on adjustments to the basis of annuity contracts sold, see section 1021.

(b) In the case of a transfer of such a contract without valuable consideration, the annuity starting date and the expected return under the contract shall be determined as though no such transfer had taken place. See paragraph (b) of §1.72–4. The transferee shall include the aggregate of premiums or other consideration paid or deemed to have been paid by his transferor in the aggregate of premiums or other consideration as though paid by him. In determining the transferee's investment in the contract, the transferee's aggregate amount of premiums or other consideration paid (as so found) shall be reduced by all amounts either received or deemed to have been received by himself or his transferor before the annuity starting date, or before the date on which an amount is first received as an annuity, whichever is the later, to the extent that such amounts were excludable from the gross income of the actual recipient under the applicable income tax law at the time of receipt. For treatment of amounts received subsequent to both the above dates by such transferee, but not received as annuity payments, see § 1.72–11.

§ 1.72–11 AMOUNTS NOT RECEIVED AS ANNUITY PAYMENTS.—(a) *Introductory.*—(1) This section applies to amounts received under a contract to which section 72 applies if either—

(i) Paragraph (b) of § 1.72–2 is inapplicable to such amounts,

(ii) Paragraph (b) of § 1.72–2 is applicable but the annuity payments received differ either in amount, duration, or both, from those originally provided under the contract, or

(iii) Paragraph (b) of § 1.72–2 is applicable, but such annuity payments are received by a beneficiary after the death of an annuitant (or annuitants) in full discharge of the obligation under the contract and solely because of a guarantee.

The payments referred to in subdivision (i) of this subparagraph include all amounts other than "amounts received as an annuity" as that term is defined in paragraph (b)(2) and (3) of § 1.72–2. If such amounts are received as dividends or payments in the nature of dividends, or as a return of premiums, see paragraph (b) of this section. If such amounts are paid in full discharge of the obligation under the contract and are in the nature of a refund of the consideration, see paragraph (c) of this section. If such amounts are paid upon the surrender, redemption, or maturity of the contract, see paragraph (d) of this section. The payments referred to in subdivision (ii) of this subparagraph include all annuity payments which are paid as the result of a modification or an exchange of the annuity obligations originally provided under a contract for different annuity obligations (whether or not such modification or exchange is accompanied by the payment of an amount to which subdivision (i) of this subparagraph applies). If the duration of the new annuity obligations differs from the duration of the old annuity obligations, paragraph (e) of this section applies to the new annuity obligations and paragraph (d) of this section applies to any lump sum payment received. If, however, the duration of the new annuity obligations is the same as the duration of the old obligations, paragraph (f) of this section applies to the new obligations and to any lump sum received in connection therewith. The annuity payments referred to in subdivision (iii) of this subparagraph are annuity payments which are made to a beneficiary after the death of annuitant (or annuitants) in full discharge of the obligations under a contract because of a provision in the contract requiring the payment of a guaranteed amount or minimum number of payments for a fixed period; see paragraph (c) of this section.

(2) The principles of this section apply, to the extent appropriate thereto, to amounts paid which are taxable under section 72 (except sections 72(e)(3)) in accordance with sections 402 and 403 and the regulations thereunder. The principles of this section also apply to payments made in the manner described in paragraph (b)(3)(i) of § 1.72–2.

(b) *Amounts received in the nature of dividends or similar distributions.*—(1) If dividends (or payments in the nature of dividends or a return of premiums or other considerations) are received under a contract to which section 72 applies and such payments are received before the annuity starting date or before the date on which an amount is first received as an annuity, whichever is the later, such payments are includible in the gross income of the recipient only to the extent that they, taken together with all previous payments received under the contract which were excludable from the gross income of the re-

cipient under the applicable income tax law, exceed the aggregate of premiums or other consideration paid or deemed to have been paid by the recipient. Such payments shall also be subtracted from the consideration paid (or deemed paid) both for the purpose of determining an exclusion ratio to be applied to subsequent amounts paid as an annuity and for the purpose of determining the applicability of section 72(d) and § 1.72–13, relating to employee contributions recoverable in three years.

(2) If dividends or payments in the nature of dividends are paid under a contract to which section 72 applies and such payments are received on or after the annuity starting date or the date on which an amount is first received as an annuity, whichever is later, such payments shall be fully includible in the gross income of the recipient. The receipt of such payments shall not affect the aggregate of premiums or other consideration paid nor the amounts contributed or deemed to have been contributed by an employee as otherwise calculated for purposes of section 72. Since the investment in the contract and the expected return are not affected by a payment which is fully includible in the gross income of the recipient under this rule, the exclusion ratio will not be affected by such payment and will continue to be applied to amounts received as annuity payments in the future as though such payment had not been made. This subparagraph shall apply to amounts received under a contract described in paragraph (b)(3)(i) of § 1.72–2 to the extent that the amounts received exceed the portion of the investment in the contract allocable to each taxable year in accordance with paragraph (d)(3) of § 1.72–4. Hence, such excess is fully includible in the gross income of the recipient.

(c) *Amounts received in the nature of a refund of the consideration under a contract and in full discharge of the obligation thereof.*—(1) Any amount received under a contract to which section 72 applies, if it is at least in part a refund of the consideration paid, including amounts payable to a beneficiary after the death of an annuitant by reason of a provision in the contract for a life annuity with minimum period of payments certain or with a minimum amount which must be paid in any event, shall be considered an amount received in the nature of a refund of the consideration paid for such contract. If such an amount is in full discharge of an obligation to pay a fixed amount (whether in a lump sum or otherwise) or to pay amounts for a fixed number of years (including amounts described in paragraph (b)(3)(i) of § 1.72–2), it shall be included in the gross income of the recipient only to the extent that it, when added to amounts previously received under the contract which were excludable from gross income under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(A). This paragraph shall not apply if the total of the amounts to be paid in discharge of the obligation can in any event exceed the total of the annuity payments which would otherwise fully discharge the obligation. For rules to be applied in such a case, see paragraph (e) of this section.

(2) The principles of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). A, a male employee, retired on December 31, 1954, at the age of 60. A life annuity of $75 per month was payable to him beginning January 31, 1955. The annuity contract guaranteed that if A did not live at least ten years, his beneficiary, B, would receive the monthly payments for any balance of the first ten years after A's retirement which remained at the date of A's death. Under section 72, A was deemed to have paid $3,600 toward the cost of the annuity. A lived for five years, receiving a total of $4,500 in annuity payments. After A's death, B began receiving the monthly payments of $75 beginning with the January 31, 1960, payment. B will exclude such payments from his gross income throughout 1960, 1961, and 1962, and will exclude only $18 of the first payment in 1963 from his gross income for that year. Thereafter, B will include the entire amount of all such payments in his gross income for the taxable year of receipt. This result is determined as follows:

A's investment in the contract (unadjusted)		$3, 600
Multiple from Table III of § 1.72–9 for male, age 60, where duration of guaranteed amount is 10 years	11%	
Subtract value of the refund feature to the nearest dollar (11% of $3,600)		396
Investment in the contract adjusted for the present value of the refund feature without discount for interest		$3, 204
Aggregate of premiums or other consideration paid		$3, 600
A's exclusion ratio ($3,204÷$16,380 [$900×18.2])	19.6%	
Subtract amount excludable during five years A received payments (19.6% of $4,500 [$900×5])		882
Remainder of aggregate of premiums or other consideration paid excludable from gross income of B under section 72(e)		$2, 718

As a result of the above computation, the number of payments to B which will exhaust the remainder of consideration paid which is excludable from gross income of the recipient is 36–6/25 ($2,718÷$75) and B will exclude the payments from his gross income for three years, then exclude only $18 of the first payment for the fourth year from his gross income, and thereafter include the entire amount of all payments he receives in his gross income.

Example (2). The facts are the same as in example (1), except that B, the beneficiary, elects to receive $50 per month for his life in lieu of the payments guaranteed under the original contractual obligation. Since such amounts will be received as an annuity and may, because of the length of time B may live, exceed the amount guaranteed, they are not amounts to which this paragraph applies. See paragraph (e).

Example (3). The facts are the same as in example (1), except that B, the beneficiary, elects to receive the remaining guaranteed amount in installments which are larger or smaller than the $75 per month provided until, under the terms of the contract, the guaranteed amount is exhausted. The rule of subparagraph (1) and the computation illustrated in example (1) apply to such installments since the total of such installments will not exceed the original amount guaranteed to be paid at A's death in any event.

Example (4). C pays $12,000 for a contract providing that he is to be paid an annuity of $1,000 per year for 15 years. His exclusion ratio is therefore 80 percent ($12,000÷$15,000). He directs that the annuity is to be paid to D, his beneficiary, if he should die before the full 15 year period has expired. C dies after 5 years and D is paid $1,000 in 1960. D will include $200 ($1,000−$800 [80 percent of $1,000]) in his gross income for the taxable year in which he receives the $1,000 since section 72(e) and this section do not apply to the annuity payments made in accordance with the provisions and during the term of the contract. D will continue with the same exclusion ratio used by C (80 percent).

Example (5). In 1954, E paid $50,000 into a fund and was promised an annual income for life the amount of which would depend in part upon the earnings realized from the investment of the fund in accordance with an agreed formula. The contract also specified that if E should die before ten years had elapsed, his beneficiary, F, would be paid the amounts determined annually under the formula until ten payments had been realized by E and F together. E died in 1960, having received five payments totalling $30,000. Assuming that $22,000 of this amount was properly excludable from E's gross income prior to his death, F will exclude from his gross income the payments he receives until the taxable year in which his total receipts from the fund exceeds $28,000 ($50,-000−$22,000). F will include any excess over the $28,000 in his gross income for that taxable year. Thereafter, F will include in his gross income the entire amount of any payments made to him from the fund.

(3) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received in full discharge of the obligation is the same person as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the tax attributable to the receipt of a lump sum to which this paragraph applies, see paragraph (g) of this section.

(d) *Amounts received upon the surrender, redemption, or maturity of a contract.*—(1) Any amount received upon the surrender, redemption, or maturity of a contract to which section 72 applies, which is not received as an annuity under the rules of paragraph (b) of § 1.72–2, shall be included in the gross income of the recipient to the extent that it, when added to amounts previously received under the contract and which were excludable from the gross income of the recipient under the law applicable at the time of receipt, exceeds the aggregate of premiums or other consideration paid. See section 72(e)(2)(B). If amounts are to be received as an annuity, whether in lieu of or in addition to amounts described in the preceding sentence, such amounts shall be included in the gross income of the recipient in accordance with the provisions of paragraph (e) or (f) of this section, whichever is applicable. The rule stated in the first sentence of this paragraph shall not apply to payments received as an annuity or otherwise after

the date of the first receipt of an amount as an annuity subsequent to the maturity, redemption, or surrender of the original contract. If amounts are so received and are other than amounts received as an annuity, they are includible in the gross income of the recipient. See section 72(e)(1)(A) and paragraph (b)(2) of this section.

(2) For the purpose of applying the rule contained in subparagraph (1) of this paragraph, it is immaterial whether the recipient of the amount received upon the surrender, redemption, or maturity of the contract is the same as the recipient of amounts previously received under the contract which were excludable from gross income, except in the case of a contract transferred for a valuable consideration, with respect to which see paragraph (a) of § 1.72–10. For the limit on the amount of tax attributable to the receipt of certain lump sums to which this paragraph applies, see paragraph (g) of this section.

(e) *Periodic payments received for a different term.*—If, after the date on which an amount is first received as an annuity under a contract to which section 72 applies, the terms of the contract are modified or the annuity obligations are exchanged so that periodic payments are to be received for a different term than originally provided under the contract (whether or not accompanied by the receipt of a lump sum to which paragraph (d) applies), the rules of this paragraph shall apply to such payments. Hence, the provisions of section 72(e) and paragraphs (b), (c), (d), and (f) of this section are inapplicable for the purpose of determining the includibility of such payments in gross income and the general principles of section 72 with respect to the use of an exclusion ratio shall be applied to such payments as if they were provided under a new contract received in exchange for the contract providing the original annuity payments. If such payments are received as the result of the surrender, redemption, or discharge of a contract to which section 72 applies, they shall be considered to be received as an annuity under a contract exchanged for the contract whose redemption, surrender, or discharge was involved. For the purpose of determining the extent to which the payments so received are to be included in the gross income of the recipient, an exclusion ratio shall be determined for such contract as of the later of January 1, 1954, or the first day of the first period for which an amount is received as an annuity thereunder, whichever is the later. See paragraph (b) of § 1.72–4. In determining the investment in the contract for this purpose, any lump sum amount received at the time of the exchange shall not be considered an amount to which paragraph (a)(2) of § 1.72–6 applies. However, such lump sum shall be subtracted from the aggregate of premiums or other consideration paid to the extent it is excludable as an amount not received as an annuity under this section as if it were an amount received before the annuity starting date of the contract obtained in exchange.

(f) *Periodic payments received for the same term after a lump sum withdrawal.*—(1) If, after the date of the first receipt of a payment as an annuity, the annuitant receives a lump sum and is thereafter to receive annuity payments in a reduced amount under the contract for the same term, life, or lives as originally specified in the contract, a portion of the contract shall be considered to have been surrendered or

redeemed in consideration of the payment of such lump sum and the exclusion ratio originally determined for the contract shall continue to apply to the amounts received as an annuity without regard to the fact that such amounts are less than the original amounts which were to be paid periodically. The lump sum shall be includible in the gross income of the recipient in accordance with the provisions of subparagraph (2) of this paragraph. However, except in the case of amounts to which sections 402 and 403 applies, the tax attributable to the inclusion of all or part of the lump sum in gross income shall not exceed the amount determined under section 72(e)(3) and paragraph (g) of this section.

(2) There shall be excluded from gross income that portion of the lump sum which bears the same ratio to the aggregate premiums or other consideration paid for the contract, as reduced by all amounts previously received under the contract and excludable from the gross income of the recipient under the applicable income tax law, as—

(i) In the case of payments to be made in the manner described in paragraph (b)(2) of § 1.72–2, the amount of the reduction in the annuity payments to be made thereafter bears to the annuity payments originally provided under the contract, or

(ii) In the case of a contract providing for payments to be made in the manner described in paragraph (b)(3)(i) of § 1.72–2, the amount of the reduction in the number of units per period to be paid thereafter bears to the number of units per period payable under the contract immediately befor the lump sum withdrawal.

(3) This paragraph may be illustrated by the following examples:

Example (1). Taxpayer A pays $20,000 for an annuity contract providing for payments to him of $100 per month for his life. At the annuity starting date he has a life expectancy of 20 years. His expected return is therefore $24,000 and the exclusion ratio is five-sixths. He continues to receive the original annuity payments for five years, receiving a total of $6,000, and properly excludes a total of $5,000 from his gross income in his income tax returns for those years. At the beginning of the next year, A agrees with the insurer to take a reduced annuity of $75 per month and a lump sum payment of $4,000 in cash. Of the lump sum he receives, he will include $250 and exclude $3,750 from his gross income for his taxable year of receipt, determined as follows:

Aggregate of premiums or other consideration paid	$20, 000	
Less amounts received as an annuity to the extent they were excludable from A's income	5, 000	
Remainder of the consideration		$15, 000
Ratio of the reduction in the amount of the annuity payments to the original annuity payments	$\frac{\$25}{\$100}$ or 1/4	
Lump sum received	$4, 000	
Less one-fourth of the remainder of the consideration (1/4 of $15,000)	3, 750	
Portion of the lump sum includible in gross income (to which the limit on tax of section 72(e)(3) applies)		$250

If, in this example, the annuity were a pension payable to A as a retired employee, but the facts were otherwise the same (assuming that, for instance, the $20,000 aggregate of premiums or other consideration paid were A's contributions as determined under section 72(f) and § 1.72–8) the result would be the same except that the tax attributable to the inclusion of the $250 in A's gross income would not be limited by section 72(e) (3).

Example (2). Taxpayer B pays $30,000 for a contract providing for monthly payments to be made to him for 15 years with respect to the principal and earnings of 10 units of an investment fund. B receives $12,000 during the first five years of participation and of this amount he has properly excluded a total of $10,000 from his gross income in his income returns for the taxable years, since $2,000 of $2,400 he received in each such year represented his investment divided by the term of the annuity ($30,000÷15). At the beginning of the sixth year, B agrees to take $11,000 in a lump sum and thereafter to accept the payments arising with respect to five units for the remaining ten years of payments in full discharge of the original obligations of the contract. B shall include $1,000 in his gross income for the sixth year as the result of the lump sum he receives and allocate $1,000 of his original investment in the contract to each of the remaining ten years with respect to the payments which will continue, determined as follows:

Aggregate of premiums or other consideration paid	$30,000	
Total amount received and excludable from gross income	10,000	
Remainder of the consideration		$20,000
Ratio of units discontinued to the total units originally provided	5/10, or 1/2	
Lump sum received at the time of reduction in the number of units to be paid	$11,000	
Less one-half of the remainder of the consideration (1/2 of $20,000)	10,000	
Portion of the lump sum received and includible in gross income (to which the provisions of section 72(e) (3) applies in this case)		$1,000
Remainder of the consideration less the portion of such remainder attributable to the excludable portion of the lump sum ($20,000—$10,000)	$10,000	
Remainder of the consideration properly allocable to each taxable year for the remaining ten years ($10,000÷10)		$1,000

(g) *Limit on tax attributable to the receipt of a lump sum.*—If the entire amount of the proceeds received upon the redemption, maturity, surrender, or discharge of a contract to which section 72 applies is received in a lump sum and paragraph (c), (d), or (f) of this section is applicable in determining the portion of such amount which is includible in gross income, the tax attributable to such portion shall not exceed the tax which would have been attributable thereto had such portion been received ratably in the taxable year in which received and the two preceding taxable years. The amount of tax attributable to the includible portion of the lump sum received shall be the lesser of—

(1) The difference between the amount of tax for the taxable year of receipt computed by including such portion in gross income and the amount of tax for such taxable year computed by excluding such portion from gross income; or

(2) The difference between the total amount of tax for the taxable year of receipt and the two preceding taxable years computed by including one-third of such portion in gross income for each of the three taxable years, and the total amount of the tax for the taxable year of receipt and the two preceding taxable years computed by entirely excluding such portion from the gross income of all three taxable years.

For the definition of "taxable year," see section 441(b). This paragraph shall not apply to payments excepted from the application of section 72(e)(3) under the provisions of section 402 or 403. See paragraph (a) of § 1.72–2 and paragraph (d) of § 1.72–14.

(h) *Amounts deemed to be paid or received by a transferee.*—Amounts deemed to have been paid or received by a transferee for the purposes of § 1.72–10 shall also be deemed to have been so paid or received by such transferee for the purposes of this section. Thus, if a donee is deemed to have paid the premiums or other consideration actually paid by his transferor for the purposes of section 72(g) and paragraph (b) of §1.72–10, such consideration shall be deemed premiums or other consideration paid by the donee for the purposes of this section.

§ 1.72–12 Effect of Taking an Annuity in Lieu of a Lump Sum Upon the Maturity of a Contract.—If a contract to which section 72 applies provides for the payment of a lump sum in full discharge of the obligation thereunder and the obligee entitled thereto, prior to receiving any portion of such lump sum and within 60 days after the date on which such lump sum first becomes payable, exercises an option or irrevocably agrees with the obligor to take, in lieu thereof, payments which will constitute "amounts received as an annuity", as that term is defined in paragraph (b) of § 1.72–2, no part of such lump sum shall be deemed to have been received by the obligee at the time he was first entitled thereto merely because he would have been entitled to such amount had he not exercised the option or made such an agreement with the obligor.

§ 1.72–13 Special Rule for Employee Contributions Recoverable in Three Years.—(a) *Amounts received as an annuity.*—(1) Section 72(d) provides a special rule for the treatment of amounts received as an annuity by an employee (or by the beneficiary or beneficiaries of an employee) under a contract to which section 72 applies. This special rule is applicable only in the event that—

(i) At least part of the consideration paid for the contract is contributed by the employer, and

(ii) The aggregate amount receivable as an annuity under such contract by the employee (or by his beneficiary or beneficiaries if the employee died before any amount was received as an annuity under the contract) within the 3-year period beginning on the date (whether or not before January 1, 1954) on which an amount is first received as an annuity equals or exceeds the total considera-

tion contributed (or deemed contributed under section 72(f) and § 1.72–8) by the employee as of such date as reduced by all amounts previously received and excludable from the gross income of the recipient under the applicable income tax law.

In such an event, section 72(d) provides that all amounts received as an annuity under the contract during a taxable year to which the Internal Revenue Code of 1954 applies shall be excluded from gross income until the total of the amounts excluded under that section plus all amounts excluded under prior income tax laws equals or exceeds the consideration contributed (or deemed contributed) by the employee. The excess, if any, and all amounts received by any recipient thereafter (whether or not received as an annuity), shall be fully included in gross income. See paragraph (b) of this section.

(2) If the aggregate amount receivable as an annuity under the contract within three years from the date on which an amount is first received as an annuity thereunder will not equal or exceed the consideration contributed (or deemed contributed) by the employee in accordance with the provisions of § 1.72–8, computed as of such date, the special rule of section 72(d) shall not apply to amounts received as an annuity under the contract and the general rules of section 72 shall apply thereto.

(3) The aggregate of the amounts receivable as an annuity within the prescribed 3-year period shall be the total of all annuity payments anticipatable by an employee (or a beneficiary or beneficiaries of an employee, if the employee died before any amount was received as an annuity) under the contract as a whole as defined in paragraph (a) of § 1.72–2. However, as provided in paragraph (a) of §1.72–2, the applicability of section 72(d) and this section shall be determined separately with respect to each separate plan or trust in which the employee has an interest. For example, the applicability of this section and section 72(d) to amounts received under a Civil Service Retirement annuity which is paid as the result of involuntary contributions of an employee shall be considered separately from the applicability of such sections to amounts received under such an annuity which is paid as the result of voluntary contributions of the employee.

(4) If subparagraphs (1) and (3) of this paragraph apply to amounts received as an annuity under a contract, the rule prescribed in subparagraph (1) of this paragraph shall apply to all amounts so received thereunder regardless of the fact that they may be payable (i) to more than one beneficiary, (ii) for the same or different intervals, (iii) in different sums, or (iv) for a different period certain, life, or lives.

(b) *Amounts not received as an annuity.*—If the rule of paragraph (a) of this section applies to a contract and, after the date on which an annuity payment is first received, amounts are received other than as an annuity under such contract in a taxable year to which the Internal Revenue Code of 1954 applies, they shall be included in the gross income of the recipient in accordance with the provisions of § 1.72–11. Thus, if such amounts are received as a dividend or a similar distribution after the date on which an amount is first received as an annuity under the contract, they shall be included in the gross income of the recipient (in accordance with section 72(e)(1)(A) and

paragraph (b)(2) of § 1.72–11). All other amounts not received as an annuity shall be included in the gross income of the recipient in accordance with the provisions of section 72(e)(1)(B) and paragraph (c), (d), or (f), whichever is applicable, of § 1.72–11. See section 72(e)(2).

(c) *Amounts received after the exhaustion of employee contributions.*—(1) Amounts received under a contract to which the rule of paragraph (a) applies (whether or not such amounts are received as an annuity) shall be included in the gross income of the recipient if such amounts are received after the date on which the aggregate of all amounts excluded from gross income by the recipients under section 72(d) and prior income tax laws equalled or exceeded the consideration contributed (or deemed contributed) by the employee.

(2) If the rule of paragraph (a) of this section applies to amounts received by an employee (or his beneficiary or beneficiaries) under a joint and survivor annuity contract, payments made to a prior annuitant may entirely exhaust the amounts excludable from gross income. In such case, amounts paid to the surviving annuitant (or annuitants) shall be included in gross income by such recipients.

(d) *Application of section 72(d) to a contract, trust, or plan providing for payments in a manner described in paragraph (b)(3)(i) of § 1.72–2.*—For the purpose of applying section 72(d) and this section any amount received in the nature of a periodic payment under a contract, trust, or plan which provides for the payment of amounts in a manner described in paragraph (b)(3)(i) of § 1.72–2 shall be considered an amount received as an annuity notwithstanding the provisions of any other section of the regulations under section 72. The special exclusion rule of section 72(d) and paragraph (a) of this section shall apply to all amounts so received if the first amount received, when multiplied by the number of periodic payments to be made within the three years beginning on the date of its receipt, results in an amount in excess of the aggregate premiums or other consideration contributed (or deemed contributed) by the employee as of that date. If more than one series of periodic payments is to be paid under the same contract, trust, or plan, all payments anticipatable, whether because fixed in amount or determinable in the manner described in the preceding sentence, shall be aggregated for the purpose of determining the applicability of section 72(d) to the contract, trust, or plan as a whole.

(e) *Inapplicability of section 72(d) and this section.*—Section 72(d) and this section do not apply to—

(1) Amounts received as proceeds of a life insurance contract to which section 101(a) applies, nor to

(2) Amounts paid to a surviving anuitant under a joint and survivor annuity contract to which paragraph (b)(3) of § 1.72–5 applies.

See also paragraph (d) of § 1.72–14.

§ 1.72–14 Exceptions From Application of Principles of Section 72.—(a) *Payments of interest.*—If any amount is received under an agreement to pay interest on a sum or sums held by the obligor, such amount shall not be excludable from the gross income of the

recipient under the provisions of section 72 to the extent that it is an actual interest payment. See section 72(j). An amount shall be considered to be held under an agreement to pay interest thereon if the amount payable after the term of the annuity (whether for a term certain or for a life or lives) is substantially equal to or larger than the aggregate amount of premiums or other consideration paid therefor. For this purpose, however, the aggregate amount of premiums or other consideration paid shall include all contributions made by an employer and not merely those to which section 72(f) applies.

(b) *Alimony payments.*—To the extent that payments made to a wife are includible in her gross income by reason of either or both sections 71 and 682, they shall not be excluded from the wife's gross income under the principles of section 72 although made under a contract to which that section applies. However, section 72 shall apply in the case of amounts received under such a contract if a husband and wife are entitled to make and do make a single return jointly.

(c) *Certain "face-amount certificates."*—The principles of section 72 do not apply to "face-amount certificates" described in section 72(l) which were issued before January 1, 1955.

(d) *Employer plans.*—The provisions of §§ 1.72–1 to 1.72–13, inclusive, shall be disregarded to the extent that they are inconsistent with the treatment of amounts received provided in section 402 (relating to the taxability of a distributee of an employees' trust), section 403 (relating to the taxation of employee annuities), or the regulations under either of such sections.

ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

§ 1.102 Statutory Provisions; Gifts and Inheritances.

SEC. 102. GIFTS AND INHERITANCES.

(a) GENERAL RULE.—Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) INCOME.—Subsection (a) shall not exclude from gross income—

(1) the income from any property referred to in subsection (a); or

(2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

§ 1.102–1 GIFTS AND INHERITANCE.—(a) *General Rule.*—Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74–1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances.*—The income from any

property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income.*—If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663(a)(1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of subchapter J.*—Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor.*—Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

§ 1.103 Statutory Provisions; Interest on Certain Governmental Obligations.

SEC. 103. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) General Rule.—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

(2) the obligations of the United States; or

(3) the obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States and if under the respective Acts authorizing the issue of the obligations the interest is wholly exempt from the taxes imposed by this subtitle.

(b) Exception.—Subsection (a) (2) shall not apply to interest on obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit, to the extent they represent deposits made before March 1, 1941), unless under the respective Acts authorizing the issuance thereof such interest is wholly exempt from the taxes imposed by this subtitle.

(c) Cross References.—For provisions relating to the taxable status of—

(1) Bonds and certificates of indebtedness authorized by the First Liberty Bond Act, see sections 1 and 6 of that Act (40 Stat. 35, 36; 31 U. S. C. 746, 755);

(2) Bonds issued to restore or maintain the gold reserve, see section 2 of the Act of March 14, 1900 (31 Stat. 46; 31 U. S. C. 408);

(3) Bonds, notes, certificates of indebtedness, and Treasury bills authorized by the Second Liberty Bond Act, see sections 4, 5(b) and (d), 7, 18(b), and 22(d) of that Act, as amended (40 Stat. 290; 46 Stat. 20, 775; 40 Stat. 291, 1310; 55 Stat. 8; 31 U. S. C. 752a, 754, 747, 753, 757c);

(4) Bonds, notes and certificates of indebtedness of the United States and bonds of the War Finance Corporation owned by certain nonresidents, see section 3 of the Fourth Liberty Bond Act, as amended (40 Stat. 1311, § 4; 31 U. S. C. 750);

(5) Certificates of indebtedness issued after February 4, 1910, see section 2 of the Act of that date (36 Stat. 192; 31 U. S. C. 769);

(6) Consols of 1930, see section 11 of the Act of March 14, 1900 (31 Stat. 48; 31 U. S. C. 751);

(7) Obligations and evidences of ownership issued by the United States or any of its agencies or instrumentalities on or after March 28, 1942, see section 4 of the Public Debt Act of 1941, as amended (c. 147, 61 Stat. 180; 31 U. S. C. 742a);

(8) Commodity Credit Corporation obligations, see section 5 of the Act of March 8, 1938 (52 Stat. 108; 15 U. S. C. 713a–5);

(9) Debentures issued by Federal Housing Administrator, see sections 204(d) and 207(i) of the National Housing Act, as amended (52 Stat. 14, 20; 12 U. S. C. 1710, 1713);

(10) Debentures issued to mortgagees by United States Maritime Commission, see section 1105(c) of the Merchant Marine Act, 1936, as amended (52 Stat. 972; 46 U. S. C. 1275);

(11) Federal Deposit Insurance Corporation obligations, see section 15 of the Federal Deposit Insurance Act (64 Stat. 890; 12 U. S. C. 1825);

(12) Federal Home Loan Bank obligations, see section 13 of the Federal Home Loan Bank Act, as amended (49 Stat. 295, § 8; 12 U. S. C. 1433);

(13) Federal savings and loan associations loans, see section 5(h) of the Home Owners' Loan Act of 1933, as amended (48 Stat. 133; 12 U. S. C. 1464);

(14) Federal Savings and Loan Insurance Corporation obligations, see section 402(e) of the National Housing Act (48 Stat. 1257; 12 U. S. C. 1725);

(15) Home Owners' Loan Corporation bonds, see section 4(c) of the Home Owners' Loan Act of 1933, as amended (48 Stat. 644, c. 168; 12 U. S. C. 1463);

(16) Obligations of Central Bank for Cooperatives, production credit corporations, production credit associations, and banks for cooperatives, see section 63 of the Farm Credit Act of 1933 (48 Stat. 267; 12 U. S. C. 1138c);

(17) Panama Canal bonds, see section 1 of the Act of December 21, 1904 (34 Stat. 5; 31 U. S. C. 743), section 8 of the Act of June 28, 1902 (32 Stat. 484; 31 U. S. C. 744), and section 39 of the Tariff Act of 1909 (36 Stat. 117; 31 U. S. C. 745);

(18) Philippine bonds, etc., issued before the independence of the Philippines, see section 9 of the Philippine Independence Act (48 Stat. 463; 48 U. S. C. 1239);

(19) Postal savings bonds, see section 10 of the Act of June 25, 1910 (36 Stat. 817; 39 U. S. C. 760);

(20) Puerto Rican bonds, see section 3 of the Act of March 2, 1917, as amended (50 Stat. 844; 48 U. S. C. 745);

(21) Treasury notes issued to retire national bank notes, see section 18 of the Federal Reserve Act (38 Stat. 268; 12 U. S. C. 447);

(22) United States Housing Authority obligations, see sections 5(e) and 20(b) of the United States Housing Act of 1937 (50 Stat. 890, 898; 42 U. S. C. 1405, 1420);

(23) Virgin Islands insular and municipal bonds, see section 1 of the Act of October 27, 1949 (63 Stat. 940; 48 U. S. C. 1403).

§ 1.103–1 INTEREST UPON OBLIGATIONS OF A STATE, TERRITORY, ETC.—Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia is not includible in gross income. Obligations

issued by or on behalf of the State, Territory, or possession of the United States, or a duly organized political subdivision acting by constituted authorities empowered to issue such obligations, are the obligations of a State, Territory, or possession of the United States, or a political subdivision thereof. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. The term "political subdivision", for purposes of this section, denotes any division of the State, Territory, or possession of the United States which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the State, Territory, or possession of the United States. As thus defined, a political subdivision of a State, Territory, or possession of the United States may or may not, for purposes of this section, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State, Territory, or possession of the United States.

§ 1.103-2 DIVIDENDS FROM SHARES AND STOCK OF FEDERAL AGENCIES OR INSTRUMENTALITIES.—(a) *Issued before March 28, 1942.*—(1) Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U. S. C. 931), provides that Federal land banks and national farm-loan associations, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 7 of the Federal Reserve Act of December 23, 1913 (12 U. S. C. 531), provides that Federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate. Section 13 of the Federal Home Loan Bank Act (12 U. S. C. 1433) provides that the Federal Home Loan Bank including its franchise, its capital, reserves, and surplus, its advances, and its income shall be exempt from all taxation, except taxes upon real estate. Section 5(h) of the Home Owners' Loan Act of 1933 (12 U. S. C. 1464(h)) provides that shares of Federal savings and loan associations shall, both as to their value and the income therefrom, be exempt from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States. Under the above-mentioned provisions, income consisting of dividends on stock of Federal land banks, national farm-loan associations, Federal home loan banks, and Federal reserve banks is not, in the case of stock issued before March 28, 1942, includible in gross income. Income consisting of dividends on share accounts of Federal savings and loan associations is includible in gross income but, in the case of shares issued before March 28, 1942, is not subject to the normal tax on income. For taxability of such income in the case of such stock or shares issued on or after March 28, 1942, see section 6 of the Public Debt Act of 1942 (31 U. S. C. 742a) and paragraph (b) of this section. For the time at which a stock or share is issued within the meaning of this section, see paragraph (b) of this section.

(2) Regardless of the exemption from income tax of dividends paid on the stock of Federal reserve banks, dividends paid by member banks are treated like dividends of ordinary corporations.

(3) Dividends on the stock of the central bank for cooperatives, the production credit corporations, production credit associations, and banks for cooperatives, organized under the provisions of the Farm Credit Act of 1933, constitute income to the recipients, subject to both the normal tax and surtax (see section 63 of the Farm Credit Act of 1933 (12 U. S. C. 1138c)).

(b) *Issued on or after March 28, 1942.*—(1) By virtue of the provisions of section 6 of the Public Debt Act of 1942, the tax exemption provisions set forth in paragraph (a) of this section with respect to income consisting of dividends on stock of the Federal land banks, national farm-loan associations, and Federal reserve banks, or on share accounts of Federal savings and loan associations, are not applicable in the case of dividends on such stock or shares issued on or after March 28, 1942.

(2) For the purposes of this section, a stock or share is deemed to be issued at the time and to the extent that payment therefor is made to the agency or instrumentality. The date of issuance of the certificate or other evidence of ownership of such stock or share is not determinative if payment is made at an earlier or later date. Where old stock is retired in exchange for new stock of a different character or preference, the new stock shall be deemed to have been issued at the time of the exchange rather than when the old stock was paid for. These rules may be illustrated by the following examples:

Example (1). A, the owner of an investment share account, consisting of 10 shares, in a Federal savings and loan association, has a single certificate issued before March 28, 1942, evidencing such ownership. In order that A may dispose of half of such shares, the association at his request issues, after March 2, 1942, two 5-share certificates in substitution for the 10-share certificate. The shares evidenced by the two new certificates are deemed to have been issued before March 28, 1942, the shares having been paid for before such date.

Example (2). The X Bank, a member of a Federal reserve bank, owns 50 shares of Federal reserve bank stock, evidenced by a single stock certificate issued before March 28, 1942. On December 31, 1942, the X Bank reduces the amount of its capital stock, as a result of which it is required to reduce the amount of its Federal reserve bank stock to 40 shares. It surrenders the 50-share certificate to the Federal reserve bank and receives a new 40-share certificate. The 40 shares evidenced by such certificate are deemed to have been issued before March 28, 1942. On December 31, 1943, the X Bank increases the amount of its capital stock, as a result of which it is required to purchase 10 additional shares of the Federal reserve bank stock. The Federal reserve bank issues a 10-share certificate evidencing ownership of the new shares. Of the 50 shares then owned by the X Bank, 40 were issued prior to March 28, 1942, and 10 were issued after March 2, 1942.

Example (3). A, the owner of a savings share account in the

amount of $100 in a Federal savings and loan association, has a passbook containing a certificate issued prior to March 28, 1942, evidencing such ownership. Subsequent to March 27, 1942, A deposits $10,000 in the account. With respect to the $10,000 deposit, the share is deemed to have been issued after March 27, 1942.

§ 1.103–3 INTEREST UPON NOTES SECURED BY MORTGAGES EXECUTED TO FEDERAL AGENCIES OR INSTRUMENTALITIES.—Section 26 of the Federal Farm Loan Act of July 17, 1916 (12 U. S. C. 931), and section 210 of such act, as added by section 2 of the act of March 4, 1923 (12 U. S. C. 1111), provide that first mortgages executed to Federal land banks, joint-stock land banks, or Federal intermediate credit banks, and the income derived therefrom, shall be exempt from taxation. Accordingly, income consisting of interest on promissory notes held by such banks and secured by such first mortgages is not subject to the income tax.

§ 1.103–4 INTEREST UPON UNITED STATES OBLIGATIONS.—(a) *Issued before March 1, 1941.*—(1) Interest upon obligations of the United States issued on or before September 1, 1917, is exempt from tax. In the case of obligations issued by the United States after September 1, 1917, and in the case of obligations of a corporation organized under Act of Congress, if such corporation is an instrumentality of the United States, the interest is exempt from tax only if and to the extent provided in the acts authorizing the issue thereof, as amended and supplemented.

(2) Interest on Treasury bonds issued before March 1, 1941, is exempt from Federal income taxes except surtaxes imposed upon the income or profits of individuals, associations, or corporations. However, interest on an aggregate of not exceeding $5,000 principal amount of such bonds is also exempt from surtaxes. Interest in excess of the interest on an aggregate of not exceeding $5,000 principal amount of such bonds is subject to surtax and must be included in gross income.

(3) Interest credited to postal savings accounts upon moneys deposited before March 1, 1941, in postal savings banks is wholly exempt from income tax.

(b) *Issued on or after March 1, 1941.*—(1) Under the provisions of sections 4 and 5 of the Public Debt Act of 1941, interest upon obligations issued on or after March 1, 1941, by the United States, or any agency or instrumentality thereof, shall not have any exemption, as such, from Federal income tax except in respect of any such obligations which the Federal Maritime Board and Maritime Administration (formerly United States Maritime Commission) or the Federal Housing Administration has, before March 1, 1941, contracted to issue at a future date. The interest on such obligations so contracted to be issued shall bear such tax-exemption privileges as were at the time of such contract provided in the law authorizing their issuance. For the purposes hereof, under section 4(a) of the Public Debt Act of 1941, a Territory and a possession of the United States (or any political subdivisions thereof), and the District of Columbia, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(2) In the case of obligations issued as the result of a refunding

operation, as, for example, where a corporation exchanges bonds for previously issued bonds, the refunding obligations are deemed, for the purposes of this section, to have been issued at the time of the exchange rather than at the time the original bonds were issued.

§ 1.103–5 TREASURY BOND EXEMPTION IN THE CASE OF TRUSTS OR PARTNERSHIPS.—(a) When the income of a trust is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries currently, each beneficiary is entitled to exemption as if he owned directly a proportionate part of the Treasury bonds held in trust. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trust, as the owner of the bonds held in trust, is entitled to the exemption on account of such ownership. In general, see sections 652(b) and 662(b) and the regulations thereunder.

(b) As the income of a partnership is taxable to the individual partners, each partner is entitled to exemption as if he owned directly a proportionate part of the bonds held by the partnership. For rules relating to partially tax-exempt interest see section 702(a)(7) and the regulations thereunder.

§ 1.103–6 INTEREST UPON UNITED STATES OBLIGATIONS IN THE CASE OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS, NOT ENGAGED IN BUSINESS IN THE UNITED STATES.—By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919 (31 U. S. C. 750), amending section 3 of the Fourth Liberty Bond Act of July 9, 1918 (31 U. S. C. 750), the interest received on and after March 3, 1919, on bonds, notes, and certificates of indebtedness of the United States while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, if such individual, corporation, partnership, or association is not engaged in business in the United States, is exempt from income taxes. Such exemption applies only to such bonds, notes, or certificates as have been issued before March 1, 1941. Interest derived by a nonresident alien individual, or by a foreign corporation, partnership, or association on such bonds, notes, or certificates issued on or after March 1, 1941, is subject to tax as in the case of taxpayers generally as provided in paragraph (b) of § 1.103–4.

§ 1.109 STATUTORY PROVISIONS; IMPROVEMENTS BY LESSEE ON LESSOR'S PROPERTY.

SEC. 109. IMPROVEMENTS BY LESSEE ON LESSOR'S PROPERTY.

Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

§ 1.109–1 EXCLUSION FROM GROSS INCOME OF LESSOR OF REAL PROPERTY OF VALUE OF IMPROVEMENTS ERECTED BY LESSEE.—(a) Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buidings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in

whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

(b) The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1945 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1950. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1955, when the improvements had a value of $100,000. Under the provisions of section 109, the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. As to the basis of the property in the hands of the A Corporation, see § 1.1019–1.

§ 1.110 Statutory Provisions; Income Taxes Paid by Lessee Corporation.

SEC. 110. INCOME TAXES PAID BY LESSEE CORPORATION.

If—

(1) a lease was entered into before January 1, 1954,

(2) both lessee and lessor are corporations, and

(3) under the lease, the lessee is obligated to pay, or to reimburse the lessor for, any part of the tax imposed by this subtitle on the lessor with respect to the rentals derived by the lessor from the lessee,

then gross income of the lessor does not include such payment or reimbursement, and no deduction for such payment or reimbursement shall be allowed to the lessee. For purposes of the preceding sentence, a lease shall be considered to have been entered into before January 1, 1954, if it is a renewal or continuance of a lease entered into before such date and if such renewal or continuance was made in accordance with an option contained in the lease on December 31, 1953.

§ 1.110–1 Income Taxes Paid by Lessee Corporation.—(a) If a lease was entered into before January 1, 1954, if both lessee and lessor are corporations, and if, under the lease, the lessee is obligated to pay,

or to reimburse the lessor for, any portion of the tax imposed by subtitle A of the Internal Revenue Code of 1954 upon the lessor with respect to the rentals derived by the lessor from such lease, such payment or reimbursement of tax shall be excluded from gross income of the lessor and no deduction therefor shall be allowed to the lessee. For purposes of this section, a renewal or continuance after December 31, 1953, of a lease entered into before January 1, 1954, shall be considered a lease entered into before January 1, 1954, if such renewal or continuance is made in accordance with an option contained in the original lease on December 31, 1953, or in accordance with an option contained (on December 31, 1953) in an instrument by which the original lease was renewed or continued. Thus, assume that a corporation lessor and a corporation lessee enter into a lease on January 1, 1947. The lease expires on December 31, 1953, but may be renewed for two years at the option of the lessee. On December 31, 1953, the lessee exercises his option, and the parties further agree, in writing, that the terms of the lease may be extended for an additional two years at the lessee's option. On December 31, 1955, the lessee exercises his option. The renewal period covering 1954 and 1955 are controlled by the provisions of section 110. Similarly, section 110 is applicable to the second two-year period to which the lease has been extended. However, section 110 would not be applicable to any further extension of the terms of the lease, since such further extension would not be made pursuant to an option existing on December 31, 1953.

(b) In the case of a lease to which the provisions of section 110 are not applicable, any amounts paid or reimbursed by the lessee corporation with respect to taxes imposed by subtitle A of the Internal Revenue Code of 1954 upon the lessor corporation for rentals derived by the lessor corporation under such lease shall be included in the gross income of the lessor corporation and shall, if otherwise allowable, be allowed as a deduction to the lessee corporation.

§ 1.111 Statutory Provisions; Recovery of Bad Debts, Prior Taxes, and Delinquency Amounts.

SEC. 111. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) General Rule.—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) Definitions.—For purposes of subsection (a)—

(1) Bad debt.—The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) Delinquency amount.—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) Recovery exclusion.—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a

reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) SPECIAL RULES FOR ACCUMULATED EARNINGS TAX AND FOR PERSONAL HOLDING COMPANY TAX.—In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

(1) a recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where a bad debt, prior tax, or delinquency amount was not allowable as a deduction or credit for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then a recovery exclusion shall be allowable if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541.

§ 1.111–1 RECOVERY OF CERTAIN ITEMS PREVIOUSLY DEDUCTED OR CREDITED.—(a) *General.*—Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term "recovery exclusion" as used in this section means an amount equal to the portion of the bad debts, prior taxes, and deliquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E of chapter 2 of the Internal Revenue Code of 1939).

(1) *Section 111 items.*—The term "section 111 items" as used in this section means bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore, not considered a section 111 item. Bad debts, prior taxes, and delinquency amounts are defined in section 111(b)(1), (2), and (3), respectively. An example of a delinquency amount is interest on delinquent taxes. An example of the other items not expressly referred to in section 111 but nevertheless subject to the rule of exclusion

is a loss sustained upon the sale of stock and later recovered, in whole or in part, through an action against the party from whom such stock had been purchased.

(2) *Definition of "recovery".*—Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery". Furthermore, the term "recovery" does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not excluded.

(3) *Treatment of debt deducted in more than one year by reason of partial worthlessness.*—In the case of a bad debt deducted in part for two or more prior years, each such deduction of a part of the debt is considered a separate section 111 item. A recovery with respect to such debt is considered first a recovery of those items (or portions thereof), resulting from such debt, for which there are recovery exclusions. If there are recovery exclusions for two or more items resulting from the same bad debt, such items are considered recovered in the order of the taxable years for which they were deducted, beginning with the latest. The recovery exclusion for any such item is determined by considering the recovery exclusion with respect to the prior year for which such item was deducted as being first used to offset all other applicable recoveries in the year in which the bad debt is recovered.

(4) *Special provisions as to worthless bonds, etc., which are treated as capital losses.*—Certain bad debts arising from the worthlessness of securities and certain nonbusiness bad debts are treated as losses from the sale or exchange of capital assets. See sections 165(g) and 166(d). The amounts of the deductions allowed for any year under section 1211 on account of such losses for such year are considered to be section 111 items. Any part of such losses which, under section 1211, is a deduction for a subsequent year through the capital loss carryover (any later receipt of an amount with respect to such deducted loss is a recovery) is considered a section 111 item for the year in which such loss was sustained.

(b) *Computation of recovery exclusion.*—(1) *Amount of recovery exclusion allowable for year of recovery.*—For the year of any recovery, the section 111 items which were deducted or credited for one prior year are considered as a group and the recovery thereon is considered separately from recoveries of any items which were deducted

or credited for other years. This recovery is excluded from gross income to the extent of the recovery exclusion with respect to this group of items as (i) determined for the original year for which such items were deducted or credited (see subparagraph (2) of this paragraph) and (ii) reduced by the excludable recoveries in intervening years on account of all section 111 items for such original year. A taxpayer claiming a recovery exclusion shall submit, at the time the exclusion is claimed, the computation of the recovery exclusion claimed for the original year for which the items were deducted or credited, and computations showing the amount recovered in intervening years on account of the section 111 items deducted or credited for the original year.

(2) *Determination of recovery exclusion for original year for which items were deducted or credited.*—(i) The recovery exclusion for the taxable year for which section 111 items were deducted or credited (that is, the "original taxable year") is the portion of the aggregate amount of such deductions and credits which could be disallowed without causing an increase in any tax of the taxpayer imposed under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E of chapter 2 of the Internal Revenue Code of 1939). For the purpose of such recovery exclusion, consideration must be given to the effect of net operating loss carryovers and carrybacks or capital loss carryovers.

(ii) This rule shall be applied by determining the recovery exclusion as the aggregate amount of the section 111 items for the original year for which such items were deducted or credited reduced by whichever of the following amounts is the greater:

(*a*) The difference between (*1*) the taxable income for such original year and (*2*) the taxable income computed without regard to the section 111 items for such original year.

(*b*) In the case of a taxpayer subject to any income tax in lieu of normal tax or surtax or both (except the alternative tax on capital gains imposed by section 1201, which is disregarded), the difference between (*1*) the income subject to such tax for such original year and (*2*) the income subject to such tax computed without regard to the section 111 items for such original year.

(Neither the amount determined under (*1*) nor the amount under (*2*) of (*a*) or (*b*) of this subdivision shall in any case be considered less than zero.) For this determination of the recovery exclusion, the aggregate of the section 111 items must be further decreased by the portion thereof which caused a reduction in tax in preceding or succeeding taxable years through any net operating loss carryovers or carrybacks or capital loss carryovers affected by such items. This decrease is the aggregate of the largest amount determined for each of such preceding and succeeding years under (*a*) and (*b*) of this subdivision, the computation of each carryover or carryback to the preceding or succeeding year being made under (*1*) of (*a*) and (*b*) of this subdivision with regard to the section 111 items for the original

year and such computation being made under (*2*) of (*a*) and (*b*) of this subdivision without regard to such items. For the purpose of the preceding sentence, the computations under both (*1*) and (*2*) of (*a*) and (*b*) of this subdivision shall be made without regard to any section 111 items for such preceding or succeeding year and the carryovers and carrybacks to such year shall be determined without regard to any section 111 items for years subsequent to the original year.

(iii) The determination of the recovery exclusion for original taxable years subject to the provisions of the Internal Revenue Code of 1939 shall be made under paragraph (b)(2) of § 39.22(b)(12)-1 of Regulations 118.

(3) *Example.*—The provisions of this paragraph may be illustrated by the following example:

Example. A single individual with no dependents has for his 1954 taxable year the following income and deductions:

	With deduction of section 111 items		*Without deduction of section 111 items*	
Gross income	-------	$25,000	-------	$25,000
Less deductions:				
Depreciation	$20,000	-------	$20,000	-------
Business bad debts and taxes	6,300	-------	-------	-------
Personal exemption	600	26,900	600	20,600
Taxable income or (loss)	-------	(1,900)	-------	4,400
Adjustment under section 172(d)(4)	-------	600	-------	-------
Net operating loss	-------	(1,300)	-------	-------

The full amount of the net operating loss of $1,300 is carried back and allowed as a deduction for 1952. The aggregate of the section 111 items for 1954 is $6,300 (bad debts and taxes). The recovery exclusion on account of section 111 items for 1954 is $600, determined by reducing the $6,300 aggregate of the section 111 items by $5,700, i. e., the sum of (1) the difference between the amount of the taxable income for 1954 computed without regard to the section 111 items ($4,400) and the amount of the taxable income for 1954 (not less than zero) computed by taking such items into account, and (2) the amount of the net operating loss ($1,300) which caused the reduction in tax for 1952 by reason of the carryback provisions. If in 1956 the taxpayer recovers $400 of the bad debts, all of the recovery is excluded from the income by reason of the recovery exclusion of $600 determined for the original year 1954. If in 1957 the taxpayer recovers an additional $300 of the bad debts, only $200 is excluded from gross income. That is, the recovery exclusion of $600 determined for the original year 1954 is reduced by the $400 recovered in 1956, leaving a balance of $200 which is used in 1957. The balance of the amount recovered in 1957, $100 ($300 less $200), is included in gross income for 1957.

(c) *Provisions as to taxes imposed by section 531 (relating to the accumulated earnings tax) and section 541 (relating to the tax on personal holding companies).*—A recovery exclusion allowed for purposes of subtitle A (other than section 531 or section 541) of the Internal Revenue Code of 1954 shall also be allowed for the purpose of determining the accumulated earnings tax under section 531 or the

personal holding company tax under section 541 regardless of whether or not the section 111 items on which such recovery exclusion is based resulted in a reduction of the tax under section 531 or section 541 of the Internal Revenue Code of 1954 (or corresponding provisions of prior income tax laws) for the prior taxable year. Furthermore, if there is recovery of a section 111 item which was not allowable as a deduction or credit for the prior taxable year for purposes of subtitle A (not including section 531 or section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), but was allowable for such prior taxable year in determining the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws) then for the purpose of determining the tax under section 531 or section 541 a recovery exclusion shall be allowable with respect to such recovery if the section 111 item did not result in a reduction of the tax under section 531 or section 541 (or corresponding provisions of prior income tax laws).

§ 1.112 Statutory Provisions; Certain Combat Pay of Members of the Armed Forces.

SEC. 112. CERTAIN COMBAT PAY OF MEMBERS OF THE ARMED FORCES.

(a) Enlisted Personnel.—Gross income does not include compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member—

(1) served in a combat zone during an induction period, or

(2) was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone during an induction period; but this paragraph shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subsection (c)(3) of this section.

(b) Commissioned Officers.—Gross income does not include so much of the compensation as does not exceed $200 received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which such officer—

(1) served in a combat zone during an induction period, or

(2) was hospitalized as a result of wounds, disease, or injury incurred while serving in a combat zone during an induction period; but this paragraph shall not apply for any month during any part of which there are no combatant activities in any combat zone as determined under subsection (c)(3) of this section.

(c) Definitions.—For purposes of this section—

(1) The term "commissioned officer" does not include a commissioned warrant officer.

(2) The term "combat zone" means any area which the President of the United States by Executive Order designates, for purposes of this section or corresponding provisions of prior income tax laws, as an area in which Armed Forces of the United States are or have (after June 24, 1950) engaged in combat.

(3) Service is performed in a combat zone only if performed on or after the date designated by the President by Executive Order as the date of the commencing of combatant activities in such zone, and on or before the date designated by the President by Executive Order as the date of the termination of combatant activities in such zone; except that June 25, 1950, shall be considered the date of the commencing of combatant activities in the combat zone designated in Executive Order 10195.

(4) The term "compensation" does not include pensions and retirement pay.

(5) The term "induction period" means any period during which, under laws heretofore or hereafter enacted relating to the induction of individuals for training and service in the Armed Forces of the United States, individuals (other than individuals liable for induction by reason of a prior deferment) are liable for induction for such training and service.

§ 1.112–1 COMPENSATION OF MEMBERS OF THE ARMED FORCES OF THE UNITED STATES FOR SERVICE IN A COMBAT ZONE DURING AN INDUCTION PERIOD, OR FOR SERVICE WHILE HOSPITALIZED AS A RESULT OF SUCH COMBAT-ZONE SERVICE.—(a) In addition to the exemptions and credits otherwise applicable, section 112 provides that there shall be excluded from gross income:

(1) Compensation received for active service as a member below the grade of commissioned officer in the Armed Forces of the United States for any month during any part of which such member (i) served in a combat zone during an induction period, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone.

(2) In the case of compensation received for active service as a commissioned officer in the Armed Forces of the United States for any month during any part of which such officer (i) served in a combat zone during an induction period, or (ii) was hospitalized at any place as a result of wounds, disease, or injury incurred while so serving provided that during all of such month there are combatant activities in some combat zone, so much of such compensation as does not exceed $200.

(b) The exclusions under section 112 and this section are applicable only if active service is performed in a combat zone during an induction period. Compensation is subject to exclusion whether or not it is received outside a combat zone or while the recipient is hospitalized or in a year different from that in which the service was rendered for which the compensation is paid. Service is performed in a combat zone only if it is performed in an area which the President of the United States has designated by Executive order, for the purpose of section 112, as an area in which Armed Forces of the United States are or have engaged in combat, and only if it is performed on or after the date designated by the President by Executive order as the date of the commencing of combatant activities in such zone and on or before the date designated by the President by Executive order as the date of the termination of combatant activities in such zone. Section 112(c)(3) provides that June 25, 1950, shall be considered the date of commencing of combatant activities in the combat zone designated in Executive Order 10195. In Executive Order 10585 the President designated January 31, 1955, as of midnight thereof, as the date of termination of combatant activities in the combat zone designated in Executive Order 10195. If a member of the Armed Forces serves in a combat zone for any part of a month during an induction period, he is entitled to the exclusion for such month to the same extent as if he has served in such zone, for the entire month. If a member of the Armed Forces is hospitalized for a part of a month as a result of wounds, disease, or

injury incurred while serving in such zone during an induction period, he is entitled to the exclusion for the entire month provided there are some combatant activities in any combat zone during all of such month.

(c) If an individual is hospitalized for wound, disease, or injury while serving in a combat zone, the wound, disease, or injury will, unless the contrary clearly appears, be presumed to have been incurred while serving in a combat zone. In certain cases, however, a wound, disease, or injury may have been incurred while serving in a combat zone even though the individual was not hospitalized for it while so serving. And, in exceptional cases, a wound, disease, or injury will not have been incurred while serving in a combat zone even though the individual was hospitalized for it while so serving.

(d) These principles may be illustrated by the following examples (in each case service is performed in a combat zone during an induction period):

Example (1). An individual is hospitalized in a combat zone for a specific disease after having served in such zone for three weeks. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in the combat zone.

Example (2). The facts are the same as in example (1) except that the incubation period is one year. Such disease was not incurred while serving in the combat zone.

Example (3). A member of the Air Force, stationed outside the combat zone, is shot while participating in an aerial flight over the combat zone, but is not hospitalized until he returns to his home base. Such injury was incurred while serving in a combat zone.

Example (4). An individual is hospitalized for a specific disease three weeks after having departed from a combat zone. The incubation period of such disease is from two to four weeks. Such disease was incurred while serving in a combat zone.

(e) An individual is hospitalized only until such time as his status as a hospital patient ceases by reason of his discharge from the hospital.

(f) The term "induction period" means any period in which individuals are generally subject to induction into the Armed Forces of the United States under the Universal Military Training and Service Act (50 App. U. S. C. 451) or under similar acts hereafter enacted. The term does not apply to any period in which individuals are not generally subject to induction but are subject to induction by reason of a prior deferment.

(g) The term "commissioned officer" does not include a commissioned warrant officer, and, accordingly, a commissioned warrant officer is entitled to the exclusion allowed to enlisted personnel under section 112(a). The term "compensation," for the purpose of this section, does not include pensions and retirement pay. As to who are members of the Armed Forces of the United States, see section 7701(a)(15).

(h) These exclusions are applicable without regard to the marital status of the recipient of the compensation, and if a husband and wife both meet the requirements of the statute, then each is entitled to the benefit of an exclusion. In the case of a husband and wife domiciled in a State recognized for Federal income tax purposes as a community

property State, any exclusion from gross income under section 112 operates before apportionment of the gross income of the spouses in accordance with community property law. For example, a man and his wife are domiciled in a community property State and he is entitled, as a commissioned officer, to the benefit of the exclusion of $200 for each month under section 112(b). He receives $1,000 as compensation for active service for three months in a combat zone. Of such amount, $600 is excluded from gross income under section 112(b) and only $400 is taken into account in determining the gross income of both husband and wife.

(i) A member of the Armed Forces is in active service if he is actually serving in the Armed Forces of the United States. Periods during which a member of the Armed Forces is absent from duty on account of sickness, wounds, leave, internment by the enemy, or other lawful cause are periods of active service. A member of the Armed Forces in active service in a combat zone who there becomes a prisoner of war or missing in action is deemed, for the purpose of section 112 and this section, to continue in active service in the combat zone for the period for which he is entitled to such status for military pay purposes. These exclusions apply to compensation received by a member of the Armed Forces for services rendered while in active service even though payment is received subsequent to discharge or release from active service. Compensation credited to a decedent's account for a period subsequent to the established date of his death and received by his estate will be excluded under section 112 from the gross income of the estate to the same extent that it would have been excluded from the gross income of the decedent if he had lived and received such compensation.

§ 1.113 Statutory Provisions; Mustering-Out Payments for Members of the Armed Forces.

SEC. 113. MUSTERING-OUT PAYMENTS FOR MEMBERS OF THE ARMED FORCES.

Gross income does not include amounts received during the taxable year as mustering-out payments with respect to service in the Armed Forces of the United States.

§ 1.113–1 Mustering-Out Payments for Members of the Armed Forces.—For the purposes of the exclusion from gross income under section 113 of mustering-out payments with respect to service in the Armed Forces, mustering-out payments are payments made to any recipients pursuant to the provisions of the Mustering-Out Payment Act of 1944 and Subchapter IV of the Veterans Readjustment Assistance Act of 1952. (See 38 U. S. C. 691e and 1011–1016.)

§ 1.114 Statutory Provisions; Sports Programs Conducted For the American National Red Cross.

SEC. 114. SPORTS PROGRAMS CONDUCTED FOR THE AMERICAN NATIONAL RED CROSS.

(a) General Rule.—In the case of a taxpayer which is a corporation primarily engaged in the furnishing of sports programs, gross income does not include amounts received as proceeds from a sports program conducted by the taxpayer if—

(1) the taxpayer agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) the taxpayer turns over to the American National Red Cross the proceeds from such sports program, minus the expenses paid or incurred by the taxpayer—

(A) which would not have been so paid or incurred but for such sports program, and

(B) which would be allowable as a deduction under section 162 (relating to trade or business expenses) but for subsection (b) of this section; and

(3) the facilities used for such program are not regularly used during the taxable year for the conduct of sports programs to which this subsection applies.

For purposes of this subsection, the term "proceeds from such sports program" includes all amounts paid for admission to the sports program, plus all proceeds received by the taxpayer from such program or activities carried on in connection therewith.

(b) TREATMENT OF EXPENSES.—Expenses described in subsection (a)(2) shall be allowed as a deduction under section 162 only to the extent that such expenses exceed the amount excluded from gross income by subsection (a) of this section.

§ 1.114–1 PROCEEDS FROM CERTAIN SPORTS PROGRAMS CONDUCTED FOR THE BENEFIT OF THE AMERICAN NATIONAL RED CROSS.—(a) *In general.*—Under section 114, a corporation primarily engaged in the furnishing of sports programs may exclude from its gross income amounts received as proceeds from a sports program conducted by such corporation if each of the following requirements is met:

(1) The corporation agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) The corporation turns over to the American National Red Cross all the proceeds from such sports program, less only the expense paid or incurred by such corporation which would not have been paid or incurred but for such sports program and which would be allowable as deductions as ordinary and necessary business expenses under section 162(a) except for the provisions of section 114(b); and

(3) The facilities of the corporation used in conducting such sports program are not regularly used during the taxable year for the conduct of sports programs to which section 114(a) applies.

(b) *Certain corporations ineligible.*—Section 114 does not apply in the case of a corporation organized or operated primarily to conduct or furnish, or to participate in the conduct or furnishing of, one or more sports programs for the American National Red Cross.

(c) *Proceeds from a sports program.*—The proceeds from a sports program conducted for the benefit of the American National Red Cross include all amounts received by the conducting corporation, irrespective of when received, on account of such sports program, which amounts would be includible in the gross income of such conducting corporation, except for the provisions of section 114. Where the activities carried on in connection with the sports program include the sale or rental of radio, television, or movie rights, refreshments, souvenirs, parking facilities, programs, advertising, or other goods and services, whether sold or rented directly or through concessionaires, the amounts received by the conducting corporation from such

sports program include all amounts received from such activities, but only where such amounts would not have been received by the conducting corporation but for the presentation of the particular sports program. Where the conducting corporation receives payments for concessions on an annual or seasonal basis, and such payments are not increased because of the particular sports program, such payments are not considered as proceeds from such sports program, and any expenses paid or incurred by the conducting corporation on account of such concession operations may not be taken into account under section 114(a)(2) in determining the net amount of the proceeds from such sports program which the conducting corporation is required to turn over to the American National Red Cross; nor are the proceeds of a sports program considered to include amounts received by the conducting corporation which do not constitute gross income of such corporation, such as admissions taxes or the breakage on a pari-mutuel wagering pool which is required to be paid over to the State.

(d) *Sports programs.*—(1) Section 114 applies where the program furnished by the conducting corporation consists of sports events such as baseball, football, basketball, or racing but it does not apply to programs or events such as motion pictures, circuses, or dances which are not ordinarily considered to be competitive sporting events.

(2) A sports program includes all of the events normally making up a full program in the particular sport. A single race of a racing program consisting of more than one race would not constitute a sports program, nor would one baseball or basketball game of a doubleheader program constitute a sports program.

(e) *Treatment of expenses.*—Expenses described in section 114(a)(2) shall be allowable as deductions under section 162 only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

§ 1.115 Statutory Provisions; Income of States, Municipalities, etc.

SEC. 115. INCOME OF STATES, MUNICIPALITIES, ETC.

(a) General Rule.—Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

(b) Contracts Made Before September 8, 1916, Relating to Public Utilities.—Where a State or Territory, or any political subdivision thereof, or the District of Columbia, before September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which was to acquire, construct, operate, or maintain a public utility—

(1) If—

(A) by the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such public utility before any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and

(B) a part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia,

(2) the taxpayer turns over to the American National Red Cross the proceeds from such sports program, minus the expenses paid or incurred by the taxpayer—

(A) which would not have been so paid or incurred but for such sports program, and

(B) which would be allowable as a deduction under section 162 (relating to trade or business expenses) but for subsection (b) of this section; and

(3) the facilities used for such program are not regularly used during the taxable year for the conduct of sports programs to which this subsection applies.

For purposes of this subsection, the term "proceeds from such sports program" includes all amounts paid for admission to the sports program, plus all proceeds received by the taxpayer from such program or activities carried on in connection therewith.

(b) TREATMENT OF EXPENSES.—Expenses described in subsection (a)(2) shall be allowed as a deduction under section 162 only to the extent that such expenses exceed the amount excluded from gross income by subsection (a) of this section.

§ 1.114–1 PROCEEDS FROM CERTAIN SPORTS PROGRAMS CONDUCTED FOR THE BENEFIT OF THE AMERICAN NATIONAL RED CROSS.—(a) *In general.*—Under section 114, a corporation primarily engaged in the furnishing of sports programs may exclude from its gross income amounts received as proceeds from a sports program conducted by such corporation if each of the following requirements is met:

(1) The corporation agrees in writing with the American National Red Cross to conduct such sports program exclusively for the benefit of the American National Red Cross;

(2) The corporation turns over to the American National Red Cross all the proceeds from such sports program, less only the expense paid or incurred by such corporation which would not have been paid or incurred but for such sports program and which would be allowable as deductions as ordinary and necessary business expenses under section 162(a) except for the provisions of section 114(b); and

(3) The facilities of the corporation used in conducting such sports program are not regularly used during the taxable year for the conduct of sports programs to which section 114(a) applies.

(b) *Certain corporations ineligible.*—Section 114 does not apply in the case of a corporation organized or operated primarily to conduct or furnish, or to participate in the conduct or furnishing of, one or more sports programs for the American National Red Cross.

(c) *Proceeds from a sports program.*—The proceeds from a sports program conducted for the benefit of the American National Red Cross include all amounts received by the conducting corporation, irrespective of when received, on account of such sports program, which amounts would be includible in the gross income of such conducting corporation, except for the provisions of section 114. Where the activities carried on in connection with the sports program include the sale or rental of radio, television, or movie rights, refreshments, souvenirs, parking facilities, programs, advertising, or other goods and services, whether sold or rented directly or through concessionaires, the amounts received by the conducting corporation from such

sports program include all amounts received from such activities, but only where such amounts would not have been received by the conducting corporation but for the presentation of the particular sports program. Where the conducting corporation receives payments for concessions on an annual or seasonal basis, and such payments are not increased because of the particular sports program, such payments are not considered as proceeds from such sports program, and any expenses paid or incurred by the conducting corporation on account of such concession operations may not be taken into account under section 114(a)(2) in determining the net amount of the proceeds from such sports program which the conducting corporation is required to turn over to the American National Red Cross; nor are the proceeds of a sports program considered to include amounts received by the conducting corporation which do not constitute gross income of such corporation, such as admissions taxes or the breakage on a pari-mutuel wagering pool which is required to be paid over to the State.

(d) *Sports programs.*—(1) Section 114 applies where the program furnished by the conducting corporation consists of sports events such as baseball, football, basketball, or racing but it does not apply to programs or events such as motion pictures, circuses, or dances which are not ordinarily considered to be competitive sporting events.

(2) A sports program includes all of the events normally making up a full program in the particular sport. A single race of a racing program consisting of more than one race would not constitute a sports program, nor would one baseball or basketball game of a doubleheader program constitute a sports program.

(e) *Treatment of expenses.*—Expenses described in section 114(a)-(2) shall be allowable as deductions under section 162 only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

§ 1.115 Statutory Provisions; Income of States, Municipalities, etc.

SEC. 115. INCOME OF STATES, MUNICIPALITIES, ETC.

(a) General Rule.—Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or Territory, or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

(b) Contracts Made Before September 8, 1916, Relating to Public Utilities.—Where a State or Territory, or any political subdivision thereof, or the District of Columbia, before September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which was to acquire, construct, operate, or maintain a public utility—

(1) If—

(A) by the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such public utility before any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and

(B) a part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia,

then a tax on the taxable income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under regulations prescribed by the Secretary or his delegate) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this subtitle) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the taxable income from the operation of such public utility for such taxable year.

(2) If by the terms of such contract no part of the proceeds from the operation of the public utility for the taxable year would, irrespective of the tax imposed by this subtitle, accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax on the taxable income of such person from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle.

(c) Contracts Made Before May 29, 1928, Relating to Bridge Acquisitions.—Where a State or political subdivision thereof, pursuant to a contract entered into before May 29, 1928, to which it is not a party, is to acquire a bridge—

(1) If—

(A) by the terms of such contract the tax imposed by this subtitle is to be paid out of the proceeds from the operation of such bridge before any division of such proceeds, and

(B) a part of such proceeds for the taxable year would (but for the imposition of the tax imposed by this subtitle) accrue directly to or for the use of or would be applied for the benefit of such State or political subdivision.

then a tax on the taxable income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle, but there shall be refunded to such State or political subdivision (under regulations to be prescribed by the Secretary or his delegate) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this subtitle) would have accrued directly to or for the use of or would be applied for the benefit of such State or political subdivision bears to the amount of the taxable income from the operation of such bridge for such taxable year. No such refund shall be made unless the entire amount of the refund is to be applied in part payment for the acquisition of such bridge.

(2) If by the terms of such contract no part of the proceeds from the operation of the bridge for the taxable year would, irrespective of the tax imposed by this subtitle, accrue directly to or for the use of or be applied for the benefit of such State or political subdivision, then the tax on the taxable income from the operation of such bridge shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this subtitle.

§ 1.115–1 Bridges To Be Acquired by State or Political Subdivisions.—(a) Any State or political subdivision thereof claiming a refund under the provisions of section 115(c) of an amount equal to all or a portion of any income tax levied, assessed, collected, and paid shall file a claim therefor on Form 843 (to which there shall be attached as exhibits the matter hereinafter prescribed) with the district director of internal revenue for the internal revenue district in which the tax was paid, which claim shall be executed on behalf of such State or political subdivision thereof by the treasurer or other fiscal officer thereof and shall contain:

(1) A statement of the name of the taxpayer, of the amount of tax levied, assessed, collected, and paid for the taxable year or period in

respect of which the claim is made, and the amount of refund thereby sought;

(2) A full statement of the facts considered by the claimant sufficient to entitle it to receive the refund, including copies of all contracts and other documents bearing on the case, and a statement that the claim is submitted under the provisions of section 115(c);

(3) A showing which will establish to the satisfaction of the district director that the fiscal officer presenting the claim has authority to receive the amount of the refund on behalf of the State or political subdivision which he assumes to represent and to apply without delay the entire amount of such refund in part payment for the acquisition of such bridge, including copies of the laws, ordinances, or similar enactments considered by the claimant sufficient to establish its authority to receive the refund and so to apply it, together with a statement that such fiscal officer will receive and immediately so apply the entire amount of the refund; and

(4) A statement, verified by a written declaration that it is made under the penalties of perjury, made by or on behalf of the taxpayer that the taxpayer thereby joins with and concurs in the request of the State or political subdivision thereof that a refund of an amount equal to all or a portion of the tax previously paid by such taxpayer be made to such State or political subdivision, that the taxpayer agrees to receive the amount refunded from the State or political subdivision to which it is paid and immediately to apply the entire amount of such refund in part payment for the acquisition of such bridge, and that if for any reason the contract which is the basis of the claim for refund is not fully executed and performed, the taxpayer will repay to the United States upon its demand the entire amount of the refund with interest at 6 percent per annum from the date the refund is made without seeking or claiming the benefit of any statute of limitations which prior thereto may have run against the United States.

(b) No refund shall be made of any amount in excess of the amount of the tax levied, assessed, collected, and paid by the taxpayer for any taxable year or period. A separate claim shall be made in respect of each separate taxable year or period. If by the terms of the contract on which the claim is based two or more States or political subdivisions of a State or States are entitled to acquire the bridge, the claim for refund in respect of each separate taxable year or period must be made jointly by the States or political subdivisions thereof so entitled. The amount refunded under section 115(c) and this section is not considered an overpayment, within the meaning of section 6611, relating to interest on overpayments, and no interest shall be allowed or paid upon the amount of the refund.

(c) A check or voucher in payment of a claim for refund allowed under section 115(c) will be drawn in the name of the fiscal officer or officers having authority, as established under paragraph (a)(3) of this section, to receive the same, and will contain an express provision that it is issued for the sole purpose and subject to the conditions prescribed in section 115(c) and this section.

§ 1.117 STATUTORY PROVISIONS; SCHOLARSHIPS AND FELLOWSHIP GRANTS.

SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

(a) GENERAL RULE.—In the case of an individual, gross income does not include—

(1) any amount received—

(A) as a scholarship at an educational institution (as defined in section 151 (e) (4)), or

(B) as a fellowship grant,

including the value of contributed services and accommodations; and

(2) any amount received to cover expenses for—

(A) travel,

(B) research,

(C) clerical help, or

(D) equipment,

which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

(b) LIMITATIONS.—

(1) INDIVIDUALS WHO ARE CANDIDATES FOR DEGREES.—In the case of an individual who is a candidate for a degree at an educational institution (as defined in section 151(e) (4)), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

(2) INDIVIDUALS WHO ARE NOT CANDIDATES FOR DEGREES.—In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151(e) (4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) CONDITIONS FOR EXCLUSION.—The grantor of the scholarship or fellowship grant is an organization described in section 501(c) (3) which is exempt from tax under section 501(a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) EXTENT OF EXCLUSION.—The amount of the scholarship or fellowship grant excluded under subsection (a) (1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151(e) (4)).

§ 1.117–1 EXCLUSION OF AMOUNTS RECEIVED AS A SCHOLARSHIP OR FELLOWSHIP GRANT.—(a) *In general.*—Any amount received by an individual as a scholarship at an educational institution or as a fellowship grant, including the value of contributed services and accommodations, shall be excluded from the gross income of the recipient, subject to the limitations set forth in section 117(b) and § 1.117–2. The exclusion from gross income of an amount which is a scholarship or fellowship grant is controlled solely by section 117. Accordingly, to the extent that a scholarship or a fellowship grant exceeds the limitations of section 117(b) and § 1.117–2, it is includible in the gross

income of the recipient notwithstanding the provisions of section 102 relating to exclusion from gross income of gifts, or section 74(b) relating to exclusion from gross income of certain prizes and awards. For definitions see § 1.117–3.

(b) *Exclusion of amounts received to cover expenses.*—(1) Subject to the limitations provided in subparagraph (2), any amount received by an individual which is specifically designated to cover expenses for travel (including meals and lodging while traveling and an allowance for travel of the individual's family), research, clerical help, or equipment, is excludable from gross income provided that such expenses are incident to a scholarship or fellowship grant which is excludable from gross income under section 117(a)(1). If, however, only a portion of a scholarship or fellowship grant is excludable from gross income under section 117(a)(1) because of the part-time employment limitation contained in section 117(b)(1) or because of the expiration of the 36 month period described in section 117(b)(2)(B), only the amount received to cover expenses incident to such excludable portion is excludable from gross income. The requirement that these expenses be incident to the scholarship or the fellowship grant means that the expenses of travel, research, clerical help, or equipment, must be incurred by the individual in order to effectuate the purpose for which the scholarship or the fellowship grant was awarded.

(2) The exclusion provided under subparagraph (1) of this paragraph is applicable only to the extent that the amount received for travel, research, clerical help, or equipment, is actually expended for such expenses by the recipient during the term of the scholarship or fellowship grant and within a reasonable time before and after such term.

(3) The portion of any amount received to cover the expenses described in subparagraph (1) of this paragraph, which is not actually expended for such expenses within the exclusion period described in subparagraph (2) of this paragraph shall, if not returned to the grantor within this period, be included in the gross income of the recipient for the taxable year in which such exclusion period expires.

§ 1.117–2 LIMITATIONS.—(a) *Individuals who are candidates for degrees.*—(1) *In general.*—Under the limitations provided by section 117(b)(1) in the case of an individual who is a candidate for a degree at an educational institution, the exclusion from gross income shall not apply (except as otherwise provided in subparagraph (2) of this paragraph) to that portion of any amount received as payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship grant. Payments for such part-time employment shall be included in the gross income of the recipient in an amount determined by reference to the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient of a scholarship or a fellowship grant. A typical example of employment under this subparagraph is the case of an individual who is required, as a condition to receiving the scholarship or the fellowship grant, to perform part-time teaching services. A requirement that the individual shall furnish periodic reports to the grantor of the scholarship

or the fellowship grant for the purpose of keeping the grantor informed as to the general progress of the individual shall not be deemed to constitute the performance of services in the nature of part-time employment.

(2) *Exception.*—If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving the degree, such teaching, research, or other services on the part of the recipient of a scholarship or fellowship grant who is a candidate for such degree shall not be regarded as part-time employment within the meaning of this paragraph. Thus, if all candidates for a particular education degree are required, as part of their regular course of study or curriculum, to perform part-time practice teaching services, such services are not to be regarded as part-time employment within the meaning of this paragraph.

(b) *Individuals who are not candidates for degrees.*—(1) *Conditions for exclusion.*—In the case of an individual who is not a candidate for a degree at an educational institution, the exclusion from gross income of an amount received as a scholarship or a fellowship grant shall apply (to the extent provided in subparagraph (2) of this paragraph) only if the grantor of the scholarship or the fellowship grant is an organization described in section 501(c)(3) which is exempt from tax under section 501(a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(2) *Extent of exclusion.*—(i) In the case of an individual who is not a candidate for a degree, the amount received as a scholarship or a fellowship grant which is excludable from gross income under section 117(a)(1) shall not exceed an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during the taxable year. In determining the number of months during the period for which the recipient received amounts under a scholarship or fellowship grant, computation shall be made on the basis of whole calendar months. A whole calendar month means a period of time terminating with the day of the succeeding month numerically corresponding to the day of the month of its beginning, less one, except that if there be no corresponding day of the succeeding month the period terminates with the last day of the succeeding month. For purposes of this computation a fractional part of a calendar month consisting of a period of time including 15 days or more shall be considered to be a whole calendar month and a fractional part of a calendar month consisting of a period of time including 14 days or less shall be disregarded. For example, if an individual receives a fellowship grant on September 13 which is to expire on June 12 of the following year, the grant shall be considered to have extended for a period of 9 months. If in the preceding example the grant expired on June 27, instead of June 12, the grant shall be considered to have extended for a period of 10 months.

(ii) No exclusion shall be allowed under section 117(a)(1) to an individual who is not a candidate for a degree after the recipient has, as an individual who is not a candidate for a degree, been entitled to

an exclusion under that section for a period of 36 months. This limitation applies if the individual has received any amount which was either excluded or excludable from his gross income under section 117(a)(1) for any prior 36 months, whether or not consecutive. For example, if the individual received a fellowship grant of $7,200 for 3 years (which he elected to receive in 36 monthly installments of $200), his exclusion period would be exhausted even though he did not in any of the 36 months make use of the maximum exclusion. Accordingly, such individual would be entitled to no further exclusion from gross income witlr respect to any additional grants which he may receive as an individual who is not a candidate for a degree.

(iii) If an individual who is not a candidate for a degree receives amounts from more than one scholarship or fellowship grant during the taxable year, the total amounts received in the taxable year shall be aggregated for the purpose of computing the amount which may be excludable from gross income for such taxable year. If amounts are received from more than one scholarship or fellowship grant during the same month or months within the taxable year, such month or months shall be counted only once for the purpose of determining the number of months for which the individual received such amounts under the scholarships or fellowship grants during the taxable year. For example, if an individual receives a fellowship grant from one source for the months of January to June of the taxable year and also receives a fellowship grant from another source for the months of March through December of the same taxable year, he shall be considered to have received amounts for 12 months of the taxable year. See example (4) in subparagraph (3) of this paragraph for further illustration.

(3) *Examples.*—The application of this paragraph may be further illustrated by the following examples, it being assumed that in each example the grantor is a grantor who is described in section 117(b)(2)(A) and subparagraph (1) of this paragraph:

Example (1). B, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The grant is to commence on September 1, 1955, and is to end on May 31, 1956, so that it will extend over a period of 9 months. The amount of the fellowship grant is $4,500 and B receives this amount in monthly installments of $500 on the first day of each month commencing September 1, 1955. During the taxable year 1955, B receives a total of $2,000 with respect to the 4-month period September through December, inclusive. He may exclude $1,200 from gross income in the taxable year 1955 ($300×4) and must include the remaining $800 in gross income for that year. For the year 1956, he will exclude $1,500 ($300×5) from gross income with respect to the $2,500 which he receives in that year and must include in gross income $1,000.

Example (2). Assume the same taxpayer as in example (1) except that B receives the full amount of the grant ($4,500) on September 1, 1955. Since the amount received in the taxable year 1955 is for the full term of the fellowship grant (9 months), B may exclude $2,700 ($300×9) from gross income for the taxable

year 1955. The remaining $1,800 must be included in gross income for that year.

Example (3). C, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant in March 1955. The amount of the grant is $4,500 for a period commencing on September 1, 1955, and ending 24 months thereafter. C receives the full amount of the grant on September 1, 1955. C may exclude from gross income for the taxable year 1955, the full amount of the grant ($4,500) since this amount does not exceed an amount equal to $300 times the number of months (24) for which he received the amount of the grant during that taxable year.

Example (4). (i) F, an individual who files his return on the calendar year basis, is awarded a post-doctorate fellowship grant (Grant A) for two years commencing June 1, 1955, in the amount of $4,800. He elects to receive his grant in monthly installments of $200 commencing June 1, 1955. On March 1, 1956, F is awarded another post-doctorate fellowship grant (Grant B) for two years commencing September 1, 1956, in the amount of $7,200. He elects to receive this grant in monthly installments of $300 commencing September 1, 1956.

(ii) For the calendar year 1955, F receives $1,400 from Grant A which he is entitled to exclude from gross income since it does not exceed an amount equal to $300 times the number of months (7) for which he received amounts under the grant in the taxable year.

(iii) For the calendar year 1956, F receives $3,600 as the aggregate of amounts received under fellowship grants ($2,400 from Grant A and $1,200 from Grant B). F will be entitled to exclude the entire amount of $3,600 from gross income for the calendar year 1956 since such amount does not exceed an amount equal to $300 times the number of months (12) for which he received amounts under the grants in the taxable year.

(iv) For the calendar year 1957, F receives $4,600 as the aggregate of amounts received under fellowship grants ($1,000 from Grant A and $3,600 from Grant B). F will be entitled to exclude $3,600 ($300×12) from gross income for the calendar year 1957 and he will have to include $1,000 in gross income.

(v) For the calendar year 1958, F receives $2,400 from Grant B. F is entitled to exclude $1,500 ($300×5) from gross income for the calendar year 1958 and he will have to include $900 in gross income. While F receives amounts under fellowship Grant B for 8 months during the calendar year 1958, he is limited to an amount equal to $300 times 5 (months) because of the fact that he has already been entitled to exclude (and has in fact excluded) amounts received as a fellowship grant for a period of 31 months. Accordingly, he can only exclude amounts received under the fellowship grant for 5 months during the calendar year 1958, because of the 36–month limitation period. The fact that he was entitled to exclude only $1,400 ($200 a month for 7 months) instead of the maximum amount of $2,100 ($300×7) in 1955, is immaterial and the limitation period of 36 months is applicable.

(vi) The following chart illustrates the computation of the number of months for which F received amounts under the fellowship grants during the respective taxable years and the computation of the total amounts received under the fellowship grants during each taxable year:

Period for which received and source	*Number of months*	*Amounts received*
1955:		
June 1 to December 31	7	
Grant A	------	$1,400
Grant B	------	None
Aggregate	7	$1,400
1956:		
January 1 to August 31	8	-------
Grant A	------	$1,600
Grant B	------	None
September 1 to December 31	4	-------
Grant A	------	800
Grant B	------	1,200
Aggregate	12	$3,600
1957:		
January 1 to May 31	5	-------
Grant A	------	$1,000
Grant B	------	1,500
June 1 to December 31	7	-------
Grant A	------	None
Grant B	------	2,100
Aggregate	12	$4,600
1958:		
January 1 to August 31	8	-------
Grant A	------	None
Grant B	------	$2,400
Aggregate	8	$2,400

§ 1.117-3 DEFINITIONS.—(a) *Scholarship.*—A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

(b) *Educational institution.*—For definition of "educational institution" section 117 adopts the definition of that term which is prescribed in section 151(e)(4). Accordingly, for purposes of section 117 the term "educational institution" means only an educational in-

stitution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. See section 151(e)(4) and regulations thereunder.

(c) *Fellowship grant.*—A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to an individual to aid him in the pursuit of study or research. The term also includes any amount received in the nature of a family allowance as a part of a fellowship grant. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in the pursuit of study or research where the grantor is motivated by family or philanthropic considerations.

(d) *Contributed services and accommodations.*—The term "contributed services and accommodations" means such services and accommodations as room, board, laundry service, and similar services or accommodations which are received by an individual as a part of a scholarship or fellowship grant.

(e) *Candidate for a degree.*—The term "candidate for a degree" means an individual, whether an undergraduate or a graduate, who is pursuing studies or conducting research to meet the requirements for an academic or professional degree conferred by colleges or universities. It is not essential that such study or research be pursued or conducted at an educational institution which confers such degrees if the purpose thereof is to meet the requirements for a degree of a college or university which does confer such degrees. A student who receives a scholarship for study at a secondary school or other educational institution is considered to be a "candidate for a degree."

§ 1.117–4 ITEMS NOT CONSIDERED AS SCHOLARSHIPS OR FELLOWSHIP GRANTS.—The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:

(a) *Educational and training allowances to veterans.*—Educational and training allowances to a veteran pursuant to the Servicemen's Readjustment Act of 1944 or the Veterans' Readjustment Assistance Act of 1952.

(b) *Allowances to members of the Armed Forces of the United States.*—Tuition and subsistence allowances to members of the Armed Forces of the United States who are students at an educational institution operated by the United States or approved by the United States for their education and training, such as the United States Naval Academy and the United States Military Academy.

(c) *Amounts paid as compensation for services or primarily for the benefit of the grantor.*

(1) Except as provided in § 1.117–2(a), any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation

for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

§ 1.118 Statutory Provisions; Contributions to the Capital of a Corporation.

SEC. 118. CONTRIBUTIONS TO THE CAPITAL OF A CORPORATION.

(a) General Rule.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

(b) Cross Reference.—For basis of property acquired by a corporation through a contribution to its capital, see section 362.

§ 1.118–1 Contributions to the Capital of a Corporation.—In the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company. Section 118 also applies to contributions to capital made by persons other than shareholders. For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities. However, the exclusion does not apply to any money or property transferred to the corporation in consideration for goods or services rendered, or to subsidies paid for the purpose of inducing the taxpayer to limit production. See section 362 for the basis of property acquired by a corporation through a contribution to its capital by its stockholders or by nonstockholders.

§ 1.119 STATUTORY PROVISIONS; MEALS OR LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER.

SEC. 119. MEALS OR LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER.

There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—

(1) in the case of meals, the meals are furnished on the business premises of the employer, or

(2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

§ 1.119-1 MEALS AND LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER.—(a) *Meals.*—(1) The value of meals furnished to an employee by his employer shall be excluded from the employee's gross income if two tests are met: (i) The meals are furnished on the business premises of the employer, and (ii) the meals are furnished for the convenience of the employer. The exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such meals are furnished as compensation.

(2) The question of whether meals are furnished for the convenience of the employer is one of fact to be determined by analysis of all the facts and circumstances in each case. Ordinarily, meals furnished to the employee during the working day will be deemed furnished for the convenience of the employer. Likewise, meals furnished immediately preceding or immediately following working hours of the employee will be deemed to be for the convenience of the employer if the furnishing of such meals serves a business purpose of the employer other than providing additional or indirect compensation to the employee. Meals furnished on nonworking days, or at times when the employee's presence on the employer's business premises does not serve a business purpose of the employer, do not qualify for the exclusion. If the employee is required to occupy living quarters on the business premises of his employer as a condition of his employment (as defined in paragraph (b) of this section), the exclusion applies to the value of any meals furnished to the employee on such premises. There is no requirement that the employee accept such meals as a condition of employment to qualify for the exclusion.

(b) *Lodging.*—The value of lodging furnished to an employee by his employer shall be excluded from the employee's gross income if three tests are met: (1) The lodging is furnished on the business premises of the employer, (2) the lodging is furnished for the convenience of the employer, and (3) the employee is required to accept such lodging as a condition of his employment. The phrase "required as a condition of his employment" means required in order for the employee to perform properly the duties of his employment. The exclusion shall apply irrespective of whether under an employment contract or a statute fixing the terms of employment such lodging is furnished as compensation.

(c) *Rules.*—(1) For purposes of this section, the term "business premises of the employer" generally means the place of employment of the employee. For example, meals and lodging furnished in the employer's home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on leased land would be regarded as furnished on the business premises of the employer.

(2) The exclusion provided by section 119 applies only to meals and lodging furnished in kind, without charge or cost to the employee. If the employee has an option to receive additional compensation in lieu of meals or lodging in kind, or is required to reimburse the employer for meals or lodging furnished in kind, the value of such meals and lodging is not excluded from gross income. However, the mere fact that an employee, at his option, may decline to accept meals and lodging tendered in kind will not of itself require inclusion of the value thereof in gross income. Cash allowances for meals or lodging received by an employee are includible in gross income to the extent that such allowances constitute compensation.

(d) *Examples.*—The provisions of section 119 may be illustrated by the following examples:

Example (1). A waitress who works from 7 a. m. to 4 p. m. is furnished without charge two meals a workday. In order to insure that the waitress will commence work on time, the employer encourages her to have her breakfast on his business premises before starting work, although she is not required to have her breakfast there. She is required to have her lunch on such premises. The waitress is permitted to exclude the value of these meals from her gross income under paragraph (a) of this section.

Example (2). The waitress in example (1) is allowed to have meals on the employer's premises without charge on her days off. The waitress is not permitted to exclude the value of such meals from her gross income.

Example (3). A Civil Service employee of a State is employed at an institution and is required by his employer to be available for duty at any time. Accordingly, the employer furnishes the employee with meals and lodging at the institution. Under the applicable State statute, his meals and lodging are regarded as part of the employee's compensation. The employee would nevertheless be entitled to exclude the value of such meals and lodging from his gross income.

Example (4). An employee of an institution is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving a cash allowance in addition to his regular salary. If he elects to reside at the instiution the value to the employee of the lodging furnished by the employer will be includible in the employee's gross income because his residence at the institution is not required in order for him to perform properly the duties of his employment.

§ 1.120 Statutory Provisions; Statutory Subsistence Allowance Received by Police.

SEC. 120. STATUTORY SUBSISTENCE ALLOWANCE RECEIVED BY POLICE.

(a) General Rule.—Gross income does not include any amount received as a statutory subsistence allowance by an individual who is employed as a police official by a State, a Territory, or a possession of the United States, by any political subdivision of any of the foregoing, or by the District of Columbia.

(b) Limitations.—

(1) Amounts to which subsection (a) applies shall not exceed $5 per day.

(2) If any individual receives a subsistence allowance to which subsection (a) applies, no deduction shall be allowed under any other provision of this chapter for expenses in respect of which he has received such allowance, except to the extent that such expenses exceed the amount excludable under subsection (a) and the excess is otherwise allowable as a deduction under this chapter.

§ 1.120–1 Statutory Subsistence Allowance Received by Police.—(a) Section 120 excludes from the gross income of an individual employed as a police official by a State, Territory, or possession of the United States, by any of their political subdivisions, or by the District of Columbia, any amount received as a statutory subsistence allowance to the extent that such allowance does not exceed $5 per day. For purposes of this section, the term "statutory subsistence allowance" means an established amount, apart from salary or other compensation, which is authorized under the laws of a State, a Territory, or a possession of the United States, by any political subdivision of any of the foregoing, or by the District of Columbia, to be paid to an individual who is employed as a police official of such governmental unit for meals and other incidental expenses in connection with his official duties. A subsistence allowance paid to a police official by any of the foregoing governmental units which is not so provided by statute may not be excluded from gross income under the provisions of section 120. The term "police official" includes an employee of any of the foregoing governmental units who has police duties, such as a sheriff, a detective, a policeman, or a State police trooper, however designated.

(b) The exclusion provided by section 120 is to be computed on a daily basis, that is, for each day for which the statutory allowance is paid. If the statute providing the allowance does not specify the daily amount of such allowance, the allowance shall be converted to a daily basis for the purpose of applying the limitation provided herein. For example, if a State statute provides for a weekly subsistence allowance, the daily amount is to be determined by dividing the weekly amount by the number of days for which the allowance is paid. Thus, if a State trooper receives a weekly statutory subsistence allowance of $40 for 5 days of the week, the daily amount would be $8, that is, $40 divided by 5. However, for purposes of this section, only $5 per day may be excluded, or $25 on a weekly basis.

(c) Expenses in respect of which the allowance under section 120 is paid may not be deducted under any provision of the income tax laws except to the extent that (1) such expenses exceed the amount of the exclusion, and (2) the excess is otherwise allowable as a deduction. For example, if a State statute provides a subsistence allowance of $3

per day and the taxpayer, a State trooper, incurs expenditures of \$4.50 for meals while away from home overnight on official police duties only \$3 would be excludable under this section. Expenses relating to such exclusion (\$3) may not be deducted under any provision of the income tax laws. However, the remaining \$1.50 may be an allowable deduction under section 162 as traveling expenses while away from home in the performance of official duties. See § 1.162–2.

§ 1.121 Statutory Provisions; Cross References to Other Acts.

SEC. 121. CROSS REFERENCES TO OTHER ACTS.

(a) For exemption of—

(1) Adjustments of indebtedness under wage earners' plans, see section 679 of the Bankruptcy Act (52 Stat. 938; 11 U. S. C. 1079);

(2) Allowances and expenditures to meet losses sustained by persons serving the United States abroad, due to appreciation of foreign currencies, see the Acts of March 6, 1934 (48 Stat. 466; 5 U. S. C. 118c) and April 25, 1938 (52 Stat. 221; 5 U. S. C. 118c–1);

(3) Amounts credited to the Maritime Administration under section 9(b) (6) of the Merchant Ship Sales Act of 1946, see section 9(c) (1) of that Act (60 Stat. 48; 50 U. S. C. App. 1742);

(4) Benefits under World War Adjusted Compensation Act, see section 308 of that Act, as amended (43 Stat. 125; 44 Stat. 827, § 3; 38 U. S. C. 618);

(5) Benefits under World War Veterans' Act, 1924, see section 3 of the Act of August 12, 1935 (49 Stat. 609; 38 U. S. C. 454a);

(6) Dividends and interest derived from certain preferred stock by Reconstruction Finance Corporation, see section 304 of the Act of March 9, 1933, as amended (49 Stat. 1185; 12 U. S. C. 51d);

(7) Earnings of ship contractors deposited in special reserve funds, see section 607(h) of the Merchant Marine Act, 1936, as amended (52 Stat. 961, § 28; 46 U. S. C. 1177);

(8) Income derived from Federal Reserve banks, including capital stock and surplus, see section 7 of the Federal Reserve Act (38 Stat. 258; 12 U. S. C. 531);

(9) Income derived from Ogdensburg bridge across Saint Lawrence River, see section 4 of the Act of June 14, 1933, as amended (54 Stat. 259, § 2);

(10) Income derived from Owensboro bridge across Ohio River and nearby ferries, see section 4 of the Act of August 14, 1937 (50 Stat. 643);

(11) Income derived from Saint Clair River bridge and ferries, see section 4 of the Act of June 25, 1930, as amended (48 Stat. 140, § 1);

(12) Leave compensation payments under section 6 of Armed Forces Leave Act of 1946, see section 7 of that Act (60 Stat. 967; 37 U. S. C. 36);

(13) Mustering-out payments made to or on account of veterans under the Mustering-Out Payment Act of 1944, see section 5(a) of that Act (58 Stat. 10; 38 U. S. C. 691e);

(14) Railroad retirement annuities and pensions, see section 12 of the Railroad Retirement Act of 1935, as amended (50 Stat. 316; 45 U. S. C. 228l);

(15) Railroad unemployment benefits, see section 2(e) of the Railroad Unemployment Insurance Act, as amended (52 Stat. 1097; 53 Stat. 845, § 9; 45 U. S. C. 352);

(16) Special pensions of persons on Army and Navy medal of honor roll, see section 3 of the Act of April 27, 1916 (39 Stat. 54; 38 U. S. C. 393);

(17) Gain derived from the sale or other disposition of Treasury Bills, issued after June 17, 1930, under the Second Liberty Bond Act, as amended, see Act of June 17, 1930 (C. 512, 46 Stat. 775; 31 U. S. C. 754);

(18) Dependency and indemnity compensation paid to survivors of members of a uniformed service and certain other persons, see section 210 of the Servicemen's and Veterans' Survivor Benefits Act.

(b) For extension of military income-tax-exemption benefits to commis-

416926°—57——9

sioned officers of Public Health Service in certain circumstances, see section 212 of the Public Health Service Act (58 Stat. 689; 42 U. S. C. 213).

[Sec. 121(a) (18) added by section 501(t) of P. L. 881 (84th Cong.) effective January 1, 1957]

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

§ 1.167(a) STATUTORY PROVISIONS; DEPRECIATION; GENERAL RULE.

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

§ 1.167(a)-1 DEPRECIATION IN GENERAL.—(a) *Reasonable allowance.*—Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167 (b)–2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)–1, 1.167(b)–2, and 1.167(b)–3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

§ 1.167(a)–2 TANGIBLE PROPERTY.—The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

§ 1.167(a)–3 INTANGIBLES.—If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance

will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder.

§ 1.167(a)-4 LEASED PROPERTY.—Capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization. If the useful life of such improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under section 167. See §§ 1.167(b)-0, 1.167(b)-1, 1.167(b)-2, 1.167(b)-3, and 1.167(b)-4 for methods of computing such depreciation allowances. If, on the other hand, the estimated useful life of such property in the hands of the taxpayer, determined without regard to the terms of the lease, would be longer than the remaining period of such lease, the allowances shall take the form of annual deductions from gross income in an amount equal to the unrecovered cost of such capital expenditures divided by the number of years remaining of the term of the lease. Such deductions shall be in lieu of allowances for depreciation. See section 162 and the regulations thereunder. Capital expenditures made by a lessor for the erection of buildings or other improvements shall, if subject to depreciation allowances, be recovered by him over the estimated life of the improvements without regard to the period of the lease.

§ 1.167(a)-5 APPORTIONMENT OF BASIS.—In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law.

§ 1.167(a)-6 DEPRECIATION IN SPECIAL CASES.—(a) *Depreciation of patents or copyrights.*—The cost or other basis of a patent or copyright shall be depreciated over its remaining useful life. Its cost to the patentee includes the various Government fees, cost of drawings, models, attorneys' fees, and similar expenditures. For rules applicable to research and experimental expenditures, see sections 174 and 1016 and the regulations thereunder. If a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year.

(b) *Depreciation in case of farmers.*—A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling

occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

§ 1.167(a)–7 Accounting for Depreciable Property.—(a) Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account. Assets may be grouped in an account in a variety of ways. For example, assets similar in kind with approximately the same useful lives may be grouped together. Such an account is commonly known as a group account. Another appropriate grouping might consist of assets segregated according to use without regard to useful life, for example, machinery and equipment, furniture and fixtures, or transportation equipment. Such an account is commonly known as a classified account. A broader grouping, where assets are included in the same account regardless of their character or useful lives, is commonly referred to as a composite account. For example, all the assets used in a business may be included in a single account. Group, classified, or composite accounts may be further broken down on the basis of location, dates of acquisition, cost, character, use, etc.

(b) When group, classified, or composite accounts are used with average useful lives and a normal retirement occurs, the full cost or other basis of the asset retired, unadjusted for depreciation or salvage, shall be removed from the asset account and shall be charged to the depreciation reserve. Amounts representing salvage ordinarily are credited to the depreciation reserve. Where an asset is disposed of for reasons other than normal retirement, the full cost or other basis of the asset shall be removed from the asset account, and the depreciation reserve shall be charged with the depreciation applicable to the retired asset. For rules with respect to losses on normal retirements, see § 1.167(a)–8.

(c) A taxpayer may establish as many accounts for depreciable property as he desires. Depreciation allowances shall be computed separately for each account. Such depreciation preferably should be recorded in a depreciation reserve account; however, in appropriate cases it may be recorded directly in the asset account. Where depreciation reserves are maintained, a separate reserve account shall be maintained for each asset account. The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of law relating to adjustments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of account reconciling the differ-

ences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors. Depreciation schedules filed with the income tax return shall show the accumulated reserves computed in accordance with the allowances for income tax purposes.

(d) In classified or composite accounts, the average useful life and rate shall be redetermined whenever additions, retirements, or replacements substantially alter the relative proportion of types of assets in the accounts. See example (2) in paragraph (b) of § 1.167(b)-1 for method of determining the depreciation rate for a classified or composite account.

§ 1.167(a)-8 Retirements.—(a) *Gains and losses on retirements.*—For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured

by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.*—For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.*—The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term "adjusted basis" means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of § 1.167(a)–1,

(2) In the case of a normal retirement of an asset from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset

been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

(d) *Special rule for item accounts.*—(1) As indicated in paragraph (a)(3) (ii) and (iii) of this section, a loss is recognized upon the normal retirement of an asset from a single asset account but a loss on the normal retirement of an asset in a multiple asset account is not allowable where the depreciation rate is based upon the average useful life of the assets in the account. Where a taxpayer with more than one depreciable asset chooses to set up a separate account for each such asset and the depreciation rate is based on the average useful life of such assets (so that he uses the same life for each account), the question arises whether his depreciation deductions in substance are the equivalent of those which would result from the use of multiple asset accounts and, therefore, he should be subject to the rules governing losses on retirements of assets from multiple asset accounts. Where a taxpayer has only a few depreciable assets which he chooses to account for in single asset accounts, particularly where such assets cover a relatively narrow range of lives, it cannot be said in the usual case that the allowance of losses on retirements from such accounts clearly will distort income. This results from the fact that where a taxpayer has only a few depreciable assets it is usually not possible clearly to determine that the depreciation rate is based upon the average useful life of such assets. Accordingly, it cannot be said that the taxpayer is in effect clearly operating with a multiple asset account using an average life rate so that losses should not be allowed on normal retirements. Therefore, losses normally will be allowed upon retirement of assets from single asset accounts where the taxpayer has only a few depreciable assets. On the other hand, when a taxpayer who has only a few depreciable assets chooses to account for them in single asset accounts, using for each account a depreciation rate based on the average useful life of such assets, and the assets cover a wide range of lives, the likelihood that income will be distorted is greater than where the group of assets covers a relatively narrow range of lives. In those cases where the allowance of losses would distort income, the rules with respect to the allowance of losses on normal retirement shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(2) Where a taxpayer has a large number of depreciable assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expiration of

the average life. Accordingly, if instead of accounting for a large number of similar or dissimilar depreciable assets in multiple asset accounts, the taxpayer chooses to account separately for such assets, using a rate based upon the average life of such assets, the rules with respect to the allowances of losses on normal retirements will be applied to such assets in the same manner as though the assets were accounted for in multiple asset accounts using a rate based upon average expected useful life.

(3) Where a taxpayer who does not have a large number of depreciable assets (and who therefore is not subject to subparagraph (2) of this paragraph) chooses to set up a separate account for each such asset, and has sought to compute an average life for such assets on which to base his depreciation deductions (so that he uses the same life for each account), the allowance of losses on normal retirements from such accounts may in some situations substantially distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, where a taxpayer chooses to account separately for such assets instead of accounting for them in multiple asset accounts, and the result is to substantially distort his income, the rules with respect to the allowance of losses on normal retirements shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(4) Whenever a taxpayer is treated under this paragraph as though his assets were accounted for in a multiple asset account using an average life rate, and, therefore, he is denied a loss on retirements, the unrecovered cost less salvage of each asset which was accounted for separately may be amortized in accordance with the rule stated in paragraph (e) (1) (ii) of this section.

(e) *Accounting treatment of asset retirements.*—(1) In the case of a normal retirement where under the foregoing rules no loss is recognized and where the asset is retired without disposition or abandonment, (i) if the asset was contained in a multiple asset account, the full cost of such asset, reduced by estimated salvage, shall be charged to the depreciation reserve, or (ii) if the asset was accounted for separately, the unrecovered cost or other basis, less salvage, of the asset may be amortized through annual deductions from gross income in amounts equal to the unrecovered cost or other basis of such asset, divided by the average expected useful life (not the remaining useful life) applicable to the asset at the time of retirement. For example, if an asset is retired after six years of use and at the time of retirement depreciation was being claimed on the basis of an average expected useful life of ten years, the unrecovered cost or other basis less salvage would be amortized through equal annual deductions over a period of ten years from the time of retirement.

(2) Where multiple asset accounts are used and acquisitions and retirements are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other

basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income. Conversely, where the taxpayer customarily follows a practice of reporting all receipts from salvage as ordinary taxable income such practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income.

(f) *Cross reference.*—For special rules in connection with the retirement of the last asset of a given year's acquisitions under the declining balance method, see example (2) in paragraph (b) of § 1.167(b)-2.

§ 1.167(a)-9 Obsolescence.—The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supercession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of an asset is suddenly terminated, see section 165 and the regulations thereunder. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167 (a)-10 When Depreciation Deduction Is Allowable.—(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount

of depreciation may be determined by using what is commonly described as an "averaging convention," that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167(b)–1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§ 1.167(b) STATUTORY PROVISIONS; DEPRECIATION; USE OF CERTAIN METHODS AND RATES.

SEC. 167. DEPRECIATION. * * *

(b) USE OF CERTAIN METHODS AND RATES.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

§ 1.167(b)–0 METHODS OF COMPUTING DEPRECIATION.—(a) *In general.*—Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.*—Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)–1, 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)–1. See also § 1.167(e)–1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.*—In the case of item accounts, any method which results in a reasonable allowance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified, or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167(e)–1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and, § 1.167(c)–1 for restriction on the use of certain methods. See also § 1.167(a)–7 for definition of account.

§ 1.167(b)–1 STRAIGHT LINE METHOD.—(a) *Application of method.*—Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

(b) *Illustrations.*—The straight line method is illustrated by the following examples:

Example (1). Under the straight line method items may be depreciated separately:

Year	Item	Cost or other basis less salvage	Useful life	Depreciation allowable		
				1954	1955	1956
			Years			
1954	Asset A	$1, 600	4	*$200	$400	$400
	Asset B	12, 000	40	*150	300	300

*In this example it is assumed that the assets were placed in service on July 1, 1954.

Example (2). In group, classified, or composite accounting, a number of assets with the same or different useful lives may be combined into one account, and a single rate of depreciation, i. e., the group, classified, or composite rate used for the entire account. In the case of group accounts, i. e., accounts containing assets which are similar in kind and which have approximately the same estimated useful lives, the group rate is determined from the average of the useful lives of the assets. In the case of classified or composite accounts, the classified or composite rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

Cost or other basis	*Estimated useful life, years*	*Annual depreciation*
$10, 000	5	$2, 000
10, 000	15	667
$20, 000		$2, 667

Average rate is 13.33 percent ($2,667÷$20,000) unadjusted for salvage. Assuming the estimated salvage value is 10 percent of the cost or other basis, the rate adjusted for salvage will be 13.33 percent minus 10 percent of 13.33 percent (13.33%−1.33%), or 12 percent.

Example (3). The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be 6⅔ percent, resulting in an adjusted rate of 18.67 percent. During the years illustrated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

1954—Initial investment of $12,000.
1957—Retirement $2,000, salvage realized $200.
1958—Retirement $2,000, salvage realized $200.
1959—Retirements $4,000, salvage realized $400.
1959—Additions $10,000.
1960—Retirement $2,000, no salvage realized.
1961—Retirement $2,000, no salvage realized.

Depreciable asset account and depreciation computation on average balances

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate	Allowable depreciation
1954		$12,000		$12,000	$6,000	18.67%	$1,120
1955	$12,000			12,000	12,000	18.67%	2,240
1956	12,000			12,000	12,000	18.67%	2,240
1957	12,000		$2,000	10,000	11,000	18.67%	2,054
1958	10,000		2,000	8,000	9,000	18.67%	1,680
1959	8,000	10,000	4,000	14,000	11,000	18.67%	2,054
1960	14,000		2,000	12,000	13,000	18.67%	2,427
1961	12,000		2,000	10,000	11,000	18.67%	2,054

Corresponding depreciation reserve account

Year	Depreciation reserve Jan. 1	Depreciation allowable	Current retirements	Salvage realized	Depreciation reserve Dec. 31
1954		$1,120			$1,120
1955	$1,120	2,240			3,360
1956	3,360	2,240			5,600
1957	5,600	2,054	$2,000	$200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000		4,615
1961	4,615	2,054	2,000		4,669

§ 1.167(b)–2 DECLINING BALANCE METHOD.—(a) *Application of method.*—Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(f), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See section 167(c) and § 1.167(c)–1 for restrictions on the use of the declining balance method.

(b) *Illustrations.*—The declining balance method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of 20 years was purchased on January 1, 1954, for $1,000. The normal straight line rate (without adjustment for salvage) is 5 percent, and the declining balance rate at twice the normal straight line rate is 10 percent. The annual depreciation allowances for 1954, 1955, and 1956 are as follows:

Year	*Basis*	*Declining balance rate*	*Depreciation allowance*
1954	$1,000	10%	$100
1955	900	10%	90
1956	810	10%	81

Example (2). A taxpayer filing his returns on a calendar year basis maintains a group account to which a 5 year life and a 40 percent declining balance rate are applicable. Original investment,

additions, retirements, and salvage recoveries are the same as those set forth in example (3) of § 1.167(b)-1(b). Although salvage value is not taken into consideration in computing a declining balance rate, it must be recognized and accounted for when assets are retired.

Depreciable asset account and depreciation computation using average asset and reserve balances

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Average reserve before depreciation	Net depreciable balance	Rate	Allowable depreciation
1954	---------	$12,000	---------	$12,000	$6,000	---------	$6,000	40%	$2,400
1955	$12,000	---------	---------	12,000	12,000	$2,400	9,600	40%	3,840
1956	12,000	---------	---------	12,000	12,000	6,240	5,760	40%	2,304
1957	12,000	---------	$2,000	10,000	11,000	7,644	3,356	40%	1,342
1958	10,000	---------	2,000	8,000	9,000	7,186	1,814	40%	726
1959	8,000	10,000	4,000	14,000	11,000	5,212	5,788	40%	2,315
1960	14,000	---------	2,000	12,000	13,000	4,727	8,273	40%	3,309
1961	12,000	---------	2,000	10,000	11,000	6,036	4,964	40%	1,986

Depreciation reserve

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954	---------	---------	---------	---------	---------	$2,400	$2,400
1955	$2,400	---------	---------	$2,400	$2,400	3,840	6,240
1956	6,240	---------	---------	6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000	---------	3,727	4,727	3,309	7,036
1961	7,036	2,000	---------	5,036	6,036	1,986	7,022

Where separate depreciation accounts are maintained by year of acquisition and there is an unrecovered balance at the time of the last retirement, such unrecovered balance may be deducted as part of the depreciation allowance for the year of such retirement. Thus, if the taxpayer had kept separate depreciation accounts by year of acquisition and all the retirements shown in the example above were from 1954 acquisitions, depreciation would be computed on the 1954 and 1959 acquisitions as follows:

1954 acquisitions

Year	Asset balance Jan. 1	Acquisitions	Current retirements	Asset balance Dec. 31	Average balance	Average reserve before depreciation	Net depreciable balance	Rate	Allowable depreciation
1954	---------	$12,000	---------	$12,000	$6,000	---------	$6,000	40%	$2,400
1955	$12,000	---------	---------	12,000	12,000	$2,400	9,600	40%	3,840
1956	12,000	---------	---------	12,000	12,000	6,240	5,760	40%	2,304
1957	12,000	---------	$2,000	10,000	11,000	7,644	3,356	40%	1,342
1958	10,000	---------	2,000	8,000	9,000	7,186	1,814	40%	726
1959	8,000	---------	4,000	4,000	6,000	5,212	788	40%	315
1960	4,000	---------	2,000	2,000	3,000	2,727	273	40%	109
1961	2,000	---------	2,000	---------	1,000	836	164	---------	*164

*Balance allowable as depreciation in the year of retirement of the last survivor of the 1954 acquisitions.

Depreciation reserve for 1954 acquisitions

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954						$2,400	$2,400
1955	$2,400			$2,400	$2,400	3,840	6,240
1956	6,240			6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	315	3,727
1960	3,727	2,000		1,727	2,727	109	1,836
1961	1,836	2,000		(164)	836	164	

1959 acquisitions

Year	Asset balance Jan. 1	Acquisition	Asset balance Dec. 31	Average balance	Reserve Dec. 31, before depreciation	Net depreciable balance	Rate	Allowable depreciation	Reserve Dec. 31, after depreciation
1959		$10,000	$10,000	$5,000	None	$5,000	40%	$2,000	$2,000
1960	$10,000		10,000	10,000	$2,000	8,000	40%	3,200	5,200
1961	10,000		10,000	10,000	5,200	4,800	40%	1,920	7,120

In the above example, the allowable depreciation on the 1954 acquisitions totals $11,200. This amount when increased by salvage realized in the amount of $800, equals the entire cost or other basis of the 1954 acquisitions ($12,000).

(c) *Change in estimated useful life.*—In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised useful life had been originally estimated. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20 percent is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originally determined as twelve years. Accordingly, the applicable depreciation rate will be 16⅔ percent. This rate is thereafter applied to the unrecovered cost or other basis.

§ 1.167(b)–3 SUM OF THE YEARS-DIGITS METHOD.—(a) *Applied to a single asset.*—(1) *General rule.*—Under the sum of the years-digits method annual allowances for depreciation are computed by applying changing fractions to the cost or other basis of the property reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator which remains constant is the sum of all the years digits corresponding to the estimated useful life of the asset. See section 167(c) and § 1.167(c)–1 for restrictions on the use of the sum of the years-digits method.

(i) *Illustrations.*—Computation of depreciation allowances on a single asset under the sum of the years-digits method is illustrated by the following examples:

Example (1). A new asset having an estimated useful life of five years was acquired on January 1, 1954, for $1,750. The estimated salvage is $250. For a taxpayer filing his returns on a calendar year basis, the annual depreciation allowances are as follows:

Year	*Cost or other basis less salvage*	*Fraction**	*Allowable depreciation*	*Depreciation reserve*
1954	$1,500	5/15	$500	$500
1955	1,500	4/15	400	900
1956	1,500	3/15	300	1,200
1957	1,500	2/15	200	1,400
1958	1,500	1/15	100	1,500
Unrecovered value (salvage)				$250

*The denominator of the fraction is the sum of the digits representing the years of useful life, i. e., 5, 4, 3, 2, and 1, or 15.

Example (2). Assume in connection with an asset acquired in 1954 that 3/4 of a year's depreciation is allowable in that year. The following illustrates a reasonable method of allocating depreciation:

	Depreciation for 12 months	*Allowable depreciation* 1954	1955	1956
1st year	$500	(3/4) $375	(1/4) $125	
2d year	400		(3/4) 300	(1/4) $100
3d year	300			(3/4) 225
		$375	$425	$325

(ii) *Change in useful life.*—Where in the case of a single asset, a change is justified in the useful life, subsequent computations shall be made as though the remaining useful life at the beginning of the taxable year of change were the useful life of a new asset acquired at such time and with a basis equal to the unrecovered cost or other basis of the asset at that time. For example, assume that a new asset with an estimated useful life of ten years is purchased in 1954. At the time of making out his return for 1959, the taxpayer finds that the asset has a remaining useful life of seven years from January 1, 1959. Depreciation for 1959 should then be computed as though 1959 were the first year of the life of an asset estimated to have a useful life of seven years, and the allowance for 1959 would be 7/28 of the unrecovered cost or other basis of the asset after adjustment for salvage.

(2) *Remaining life.*—(i) *Application.*—Under the sum of the years-digits method, annual allowances for depreciation may also be computed by applying changing fractions to the unrecovered cost or other basis of the asset reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the digits corresponding to the years of estimated remaining useful life of the asset. For decimal equivalents of such fractions see Table I below. For example, a new asset with an estimated useful life of 10 years is purchased January 1, 1954, for $6,000. Assuming a salvage value of $500, the depreciation allowance for 1954 is $1,000 ($5,500×0.1818, the applicable rate from

Table I). For 1955, the unrecovered balance is $4,500, and the remaining life is 9 years. The depreciation allowance for 1955 would then be $900 ($4,500×0.2000, the applicable rate from Table I).

(ii) *Table I.*—This table shows decimal equivalents of sum of the years-digits fractions corresponding to remaining lives from 1 to 100 years.

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
100.0	0.0198	94.8	0.0209	89.6	0.0221	84.4	0.0234
99.9	.0198	94.7	.0209	89.5	.0221	84.3	.0234
99.8	.0198	94.6	.0209	89.4	.0221	84.2	.0235
99.7	.0199	94.5	.0209	89.3	.0221	84.1	.0235
99.6	.0199	94.4	.0210	89.2	.0222	84.0	.0235
99.5	.0199	94.3	.0210	89.1	.0222	83.9	.0236
99.4	.0199	94.2	.0210	89.0	.0222	83.8	.0236
99.3	.0199	94.1	.0210	88.9	.0222	83.7	.0236
99.2	.0200	94.0	.0211	88.8	.0223	83.6	.0236
99.1	.0200	93.9	.0211	88.7	.0223	83.5	.0237
99.0	.0200	93.8	.0211	88.6	.0223	83.4	.0237
98.9	.0200	93.7	.0211	88.5	.0223	83.3	.0237
98.8	.0200	93.6	.0211	88.4	.0224	83.2	.0238
98.7	.0201	93.5	.0212	88.3	.0224	83.1	.0238
98.6	.0201	93.4	.0212	88.2	.0224	83.0	.0238
98.5	.0201	93.3	.0212	88.1	.0224	82.9	.0238
98.4	.0201	93.2	.0212	88.0	.0225	82.8	.0239
98.3	.0201	93.1	.0213	87.9	.0225	82.7	.0239
98.2	.0202	93.0	.0213	87.8	.0225	82.6	.0239
98.1	.0202	92.9	.0213	87.7	.0225	82.5	.0240
98.0	.0202	92.8	.0213	87.6	.0226	82.4	.0240
97.9	.0202	93.7	.0213	87.5	.0226	82.3	.0240
97.8	.0202	92.6	.0214	87.4	.0226	82.2	.0240
97.7	.0203	92.5	.0214	87.3	.0226	82.1	.0241
97.6	.0203	92.4	.0214	87.2	.0227	82.0	.0241
97.5	.0203	92.3	.0214	87.1	.0227	81.9	.0241
97.4	.0203	92.2	.0215	87.0	.0227	81.8	.0242
97.3	.0203	92.1	.0215	86.9	.0228	81.7	.0242
97.2	.0204	92.0	.0215	86.8	.0228	81.6	.0242
97.1	.0204	91.9	.0215	86.7	.0228	81.5	.0242
97.0	.0204	91.8	.0216	86.6	.0228	81.4	.0243
96.9	.0204	91.7	.0216	86.5	.0229	81.3	.0243
96.8	.0204	91.6	.0216	86.4	.0229	81.2	.0243
96.7	.0205	91.5	.0216	86.3	.0229	81.1	.0244
96.6	.0205	91.4	.0216	86.2	.0229	81.0	.0244
96.5	.0205	91.3	.0217	86.1	.0230	80.9	.0244
96.4	.0205	91.2	.0217	86.0	.0230	80.8	.0244
96.3	.0206	91.1	.0217	85.9	.0230	80.7	.0245
96.2	.0206	91.0	.0217	85.8	.0230	80.6	.0245
96.1	.0206	90.9	.0218	85.7	.0231	80.5	.0245
96.0	.0206	90.8	.0218	85.6	.0231	80.4	.0246
95.9	.0206	90.7	.0218	85.5	.0231	80.3	.0246
95.8	.0207	90.6	.0218	85.4	.0231	80.2	.0246
95.7	.0207	90.5	.0219	85.3	.0232	80.1	.0247
95.6	.0207	90.4	.0219	85.2	.0232	80.0	.0247
95.5	.0207	90.3	.0219	85.1	.0232	79.9	.0247
95.4	.0207	90.2	.0219	85.0	.0233	79.8	.0248
95.3	.0208	90.1	.0220	84.9	.0233	79.7	.0248
95.2	.0208	90.0	.0220	84.8	.0233	79.6	.0248
95.1	.0208	89.9	.0220	84.7	.0233	79.5	.0248
95.0	.0208	89.8	.0220	84.6	.0234	79.4	.0249
94.9	.0209	89.7	.0221	84.5	.0234	79.3	.0249

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
79.2	0.0249	73.1	0.0270	67.0	0.0294	60.9	0.0323
79.1	.0250	73.0	.0270	66.9	.0295	60.8	.0324
79.0	.0250	72.9	.0271	66.8	.0295	60.7	.0324
78.9	.0250	72.8	.0271	66.7	.0295	60.6	.0325
78.8	.0251	72.7	.0271	66.6	.0296	60.5	.0325
78.7	.0251	72.6	.0272	66.5	.0296	60.4	.0326
78.6	.0251	72.5	.0272	66.4	.0297	60.3	.0326
78.5	.0252	72.4	.0272	66.3	.0297	60.2	.0327
78.4	.0252	72.3	.0273	66.2	.0298	60.1	.0327
78.3	.0252	72.2	.0273	66.1	.0298	60.0	.0328
78.2	.0253	72.1	.0274	66.0	.0299	59.9	.0328
78.1	.0253	72.0	.0274	65.9	.0299	59.8	.0329
78.0	.0253	71.9	.0274	65.8	.0299	59.7	.0329
77.9	.0253	71.8	.0275	65.7	.0300	59.6	.0330
77.8	.0254	71.7	.0275	65.6	.0300	59.5	.0331
77.7	.0254	71.6	.0275	65.5	.0301	59.4	.0331
77.6	.0254	71.5	.0276	65.4	.0301	59.3	.0332
77.5	.0255	71.4	.0276	65.3	.0302	59.2	.0332
77.4	.0255	71.3	.0277	65.2	.0302	59.1	.0333
77.3	.0255	71.2	.0277	65.1	.0303	59.0	.0333
77.2	.0256	71.1	.0277	65.0	.0303	58.9	.0334
77.1	.0256	71.0	.0278	64.9	.0303	58.8	.0334
77.0	.0256	70.9	.0278	64.8	.0304	58.7	.0335
76.9	.0257	70.8	.0279	64.7	.0304	58.6	.0336
76.8	.0257	70.7	.0279	64.6	.0305	58.5	.0336
76.7	.0257	70.6	.0279	64.5	.0305	58.4	.0337
76.6	.0258	70.5	.0280	64.4	.0306	58.3	.0337
76.5	.0258	70.4	.0280	64.3	.0306	58.2	.0338
76.4	.0258	70.3	.0280	64.2	.0307	58.1	.0338
76.3	.0259	70.2	.0281	64.1	.0307	58.0	.0339
76.2	.0259	70.1	.0281	64.0	.0308	57.9	.0340
76.1	.0259	70.0	.0282	63.9	.0308	57.8	.0340
76.0	.0260	69.9	.0282	63.8	.0309	57.7	.0341
75.9	.0260	69.8	.0282	63.7	.0309	57.6	.0341
75.8	.0260	69.7	.0283	63.6	.0310	57.5	.0342
75.7	.0261	69.6	.0283	63.5	.0310	57.4	.0342
75.6	.0261	69.5	.0284	63.4	.0311	57.3	.0343
75.5	.0261	69.4	.0284	63.3	.0311	57.2	.0344
75.4	.0262	69.3	.0284	63.2	.0312	57.1	.0344
75.3	.0262	69.2	.0285	63.1	.0312	57.0	.0345
75.2	.0262	69.1	.0285	63.0	.0313	56.9	.0345
75.1	.0263	69.0	.0286	62.9	.0313	56.8	.0346
75.0	.0263	68.9	.0286	62.8	.0313	56.7	.0347
74.9	.0264	68.8	.0287	62.7	.0314	56.6	.0347
74.8	.0264	68.7	.0287	62.6	.0314	56.5	.0348
74.7	.0264	68.6	.0287	62.5	.0315	56.4	.0348
74.6	.0265	68.5	.0288	62.4	.0315	56.3	.0349
74.5	.0265	68.4	.0288	62.3	.0316	56.2	.0350
74.4	.0265	68.3	.0289	62.2	.0316	56.1	.0350
74.3	.0266	68.2	.0289	62.1	.0317	56.0	.0351
74.2	.0266	68.1	.0289	62.0	.0317	55.9	.0351
74.1	.0266	68.0	.0290	61.9	.0318	55.8	.0352
74.0	.0267	67.9	.0290	61.8	.0318	55.7	.0353
73.9	.0267	67.8	.0291	61.7	.0319	55.6	.0353
73.8	.0267	67.7	.0291	61.6	.0319	55.5	.0354
73.7	.0268	67.6	.0292	61.5	.0320	55.4	.0355
73.6	.0268	67.5	.0292	61.4	.0320	55.3	.0355
73.5	.0268	67.4	.0292	61.3	.0321	55.2	.0356
73.4	.0269	67.3	.0293	61.2	.0322	55.1	.0356
73.3	.0269	67.2	.0293	61.1	.0322	55.0	.0357
73.2	.0270	67.1	.0294	61.0	.0323	54.9	.0358

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
54.8	0.0358	48.7	0.0402	42.6	0.0459	36.5	0.0533
54.7	.0359	48.6	.0403	42.5	.0460	36.4	.0535
54.6	.0360	48.5	.0404	42.4	.0461	36.3	.0536
54.5	.0360	48.4	.0405	42.3	.0462	36.2	.0538
54.4	.0361	48.3	.0406	42.2	.0463	36.1	.0539
54.3	.0362	48.2	.0406	42.1	.0464	36.0	.0541
54.2	.0362	48.1	.0407	42.0	.0465	35.9	.0542
54.1	.0363	48.0	.0408	41.9	.0466	35.8	.0543
54.0	.0364	47.9	.0409	41.8	.0467	35.7	.0545
53.9	.0364	47.8	.0410	41.7	.0468	35.6	.0546
53.8	.0365	47.7	.0411	41.6	.0469	35.5	.0548
53.7	.0366	47.6	.0411	41.5	.0471	35.4	.0549
53.6	.0366	47.5	.0412	41.4	.0472	35.3	.0551
53.5	.0367	47.4	.0413	41.3	.0473	35.2	.0552
53.4	.0368	47.3	.0414	41.2	.0474	35.1	.0554
53.3	.0368	47.2	.0415	41.1	.0475	35.0	.0556
53.2	.0369	47.1	.0416	41.0	.0476	34.9	.0557
53.1	.0370	47.0	.0417	40.9	.0477	34.8	.0559
53.0	.0370	46.9	.0418	40.8	.0478	34.7	.0560
52.9	.0371	46.8	.0418	40.7	.0480	34.6	.0562
52.8	.0372	46.7	.0419	40.6	.0481	34.5	.0563
52.7	.0372	46.6	.0420	40.5	.0482	34.4	.0565
52.6	.0373	46.5	.0421	40.4	.0483	34.3	.0566
52.5	.0374	46.4	.0422	40.3	.0484	34.2	.0568
52.4	.0374	46.3	.0423	40.2	.0485	34.1	.0570
52.3	.0375	46.2	.0424	40.1	.0487	34.0	.0571
52.2	.0376	46.1	.0425	40.0	.0488	33.9	.0573
52.1	.0377	46.0	.0426	39.9	.0489	33.8	.0575
52.0	.0377	45.9	.0426	39.8	.0490	33.7	.0576
51.9	.0378	45.8	.0427	39.7	.0491	33.6	.0578
51.8	.0379	45.7	.0428	39.6	.0493	33.5	.0580
51.7	.0379	45.6	.0429	39.5	.0494	33.4	.0581
51.6	.0380	45.5	.0430	39.4	.0495	33.3	.0583
51.5	.0381	45.4	.0431	39.3	.0496	33.2	.0585
51.4	.0382	45.3	.0432	39.2	.0497	33.1	.0586
51.3	.0382	45.2	.0433	39.1	.0499	33.0	.0588
51.2	.0383	45.1	.0434	39.0	.0500	32.9	.0590
51.1	.0384	45.0	.0435	38.9	.0501	32.8	.0592
51.0	.0385	44.9	.0436	38.8	.0502	32.7	.0593
50.9	.0385	44.8	.0437	38.7	.0504	32.6	.0595
50.8	.0386	44.7	.0438	38.6	.0505	32.5	.0597
50.7	.0387	44.6	.0439	38.5	.0506	32.4	.0599
50.6	.0388	44.5	.0440	38.4	.0508	32.3	.0600
50.5	.0388	44.4	.0440	38.3	.0509	32.2	.0602
50.4	.0389	44.3	.0441	38.2	.0510	32.1	.0604
50.3	.0390	44.2	.0442	38.1	.0511	32.0	.0606
50.2	.0391	44.1	.0443	38.0	.0513	31.9	.0608
50.1	.0391	44.0	.0444	37.9	.0514	31.8	.0610
50.0	.0392	43.9	.0445	37.8	.0515	31.7	.0611
49.9	.0393	43.8	.0446	37.7	.0517	31.6	.0613
49.8	.0394	43.7	.0447	37.6	.0518	31.5	.0615
49.7	.0394	43.6	.0448	37.5	.0519	31.4	.0617
49.6	.0395	43.5	.0449	37.4	.0521	31.3	.0619
49.5	.0396	43.4	.0450	37.3	.0522	31.2	.0621
49.4	.0397	43.3	.0451	37.2	.0524	31.1	.0623
49.3	.0398	43.2	.0452	37.1	.0525	31.0	.0625
49.2	.0398	43.1	.0453	37.0	.0526	30.9	.0627
49.1	.0399	43.0	.0455	36.9	.0528	30.8	.0629
49.0	.0400	42.9	.0456	36.8	.0529	30.7	.0631
48.9	.0401	42.8	.0457	36.7	.0530	30.6	.0633
48.8	.0402	42.7	.0458	36.6	.0532	30.5	.0635

§ 1.167(b)-3(a)(2)(ii)

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
30.4	0.0637	24.3	0.0790	18.2	0.1041	12.1	0.1526
30.3	.0639	24.2	.0793	18.1	.1047	12.0	.1538
30.2	.0641	24.1	.0797	18.0	.1053	11.9	.1549
30.1	.0643	24.0	.0800	17.9	.1058	11.8	.1561
30.0	.0645	23.9	.0803	17.8	.1063	11.7	.1573
29.9	.0647	23.8	.0806	17.7	.1069	11.6	.1585
29.8	.0649	23.7	.0809	17.6	.1074	11.5	.1597
29.7	.0651	23.6	.0813	17.5	.1080	11.4	.1610
29.6	.0653	23.5	.0816	17.4	.1086	11.3	.1624
29.5	.0656	23.4	.0819	17.3	.1092	11.2	.1637
29.4	.0658	23.3	.0823	17.2	.1098	11.1	.1652
29.3	.0660	23.2	.0826	17.1	.1105	11.0	.1667
29.2	.0662	23.1	.0830	17.0	.1111	10.9	.1680
29.1	.0664	23.0	.0833	16.9	.1117	10.8	.1693
29.0	.0667	22.9	.0837	16.8	.1123	10.7	.1707
28.9	.0669	22.8	.0840	16.7	.1129	10.6	.1721
28.8	.0671	22.7	.0844	16.6	.1135	10.5	.1736
28.7	.0673	22.6	.0847	16.5	.1142	10.4	.1751
28.6	.0675	22.5	.0851	16.4	.1148	10.3	.1767
28.5	.0678	22.4	.0854	16.3	.1155	10.2	.1783
28.4	.0680	22.3	.0858	16.2	.1162	10.1	.1800
28.3	.0682	22.2	.0862	16.1	.1169	10.0	.1818
28.2	.0685	22.1	.0866	16.0	.1176	9.9	.1833
28.1	.0687	22.0	.0870	15.9	.1183	9.8	.1849
28.0	.0690	21.9	.0873	15.8	.1190	9.7	.1865
27.9	.0692	21.8	.0877	15.7	.1197	9.6	.1882
27.8	.0694	21.7	.0881	15.6	.1204	9.5	.1900
27.7	.0697	21.6	.0885	15.5	.1211	9.4	.1918
27.6	.0699	21.5	.0888	15.4	.1218	9.3	.1938
27.5	.0702	21.4	.0892	15.3	.1226	9.2	.1957
27.4	.0704	21.3	.0896	15.2	.1234	9.1	.1978
27.3	.0707	21.2	.0901	15.1	.1242	9.0	.2000
27.2	.0709	21.1	.0905	15.0	.1250	8.9	.2018
27.1	.0712	21.0	.0909	14.9	.1257	8.8	.2037
27.0	.0714	20.9	.0913	14.8	.1265	8.7	.2057
26.9	.0717	20.8	.0917	14.7	.1273	8.6	.2077
26.8	.0719	20.7	.0921	14.6	.1281	8.5	.2099
26.7	.0722	20.6	.0925	14.5	.1289	8.4	.2121
26.6	.0724	20.5	.0930	14.4	.1297	8.3	.2145
26.5	.0727	20.4	.0934	14.3	.1306	8.2	.2169
26.4	.0730	20.3	.0939	14.2	.1315	8.1	.2195
26.3	.0732	20.2	.0943	14.1	.1324	8.0	.2222
26.2	.0735	20.1	.0948	14.0	.1333	7.9	.2244
26.1	.0738	20.0	.0952	13.9	.1342	7.8	.2267
26.0	.0741	19.9	.0957	13.8	.1350	7.7	.2292
25.9	.0743	19.8	.0961	13.7	.1359	7.6	.2317
25.8	.0746	19.7	.0966	13.6	.1368	7.5	.2344
25.7	.0749	19.6	.0970	13.5	.1378	7.4	.2372
25.6	.0752	19.5	.0975	13.4	.1387	7.3	.2401
25.5	.0754	19.4	.0980	13.3	.1397	7.2	.2432
25.4	.0757	19.3	.0985	13.2	.1407	7.1	.2465
25.3	.0760	19.2	.0990	13.1	.1418	7.0	.2500
25.2	.0763	19.1	.0995	13.0	.1429	6.9	.2527
25.1	.0766	19.0	.1000	12.9	.1438	6.8	.2556
25.0	.0769	18.9	.1005	12.8	.1448	6.7	.2587
24.9	.0772	18.8	.1010	12.7	.1458	6.6	.2619
24.8	.0775	18.7	.1015	12.6	.1469	6.5	.2653
24.7	.0778	18.6	.1020	12.5	.1479	6.4	.2689
24.6	.0781	18.5	.1025	12.4	.1490	6.3	.2727
24.5	.0784	18.4	.1030	12.3	.1502	6.2	.2768
24.4	.0787	18.3	.1036	12.2	.1514	6.1	.2811

TABLE I.—DECIMAL EQUIVALENT FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*	*Remaining life (years)*	*Decimal equivalent*
6.0	0.2857	4.7	0.3481	3.4	0.4474	2.1	0.6364
5.9	.2892	4.6	.3538	3.3	.4583	2.0	.6667
5.8	.2929	4.5	.3600	3.2	.4706	1.9	.6786
5.7	.2969	4.4	.3667	3.1	.4844	1.8	.6923
5.6	.3011	4.3	.3739	3.0	.5000	1.7	.7083
5.5	.3056	4.2	.3818	2.9	.5088	1.6	.7273
5.4	.3103	4.1	.3905	2.8	.5185	1.5	.7500
5.3	.3155	4.0	.4000	2.7	.5294	1.4	.7778
5.2	.3210	3.9	.4063	2.6	.5417	1.3	.8125
5.1	.3269	3.8	.4130	2.5	.5556	1.2	.8571
5.0	.3333	3.7	.4205	2.4	.5714	1.1	.9167
4.9	.3379	3.6	.4286	2.3	.5897	1.0	1.0000
4.8	.3429	3.5	.4375	2.2	.6111		

NOTE: For determination of decimal equivalents of remaining lives falling between those shown in the above table, the taxpayer may use the next longest life shown in the table, interpolate from the table, or use the following formula from which the table was derived.

$$D=\frac{2R}{(W+2F)(W+1)}$$

Where: D=Decimal equivalent.
R=Remaining life.
W=Whole number of years in remaining life.
F=Fractional part of year in remaining life.

If the taxpayer desires to carry his calculations of decimal equivalents to a greater number of decimal places than is provided in the table, he may use the formula. The procedure adopted must be consistently followed thereafter.

(b) *Applied to group, classified, or composite accounts.*—(1) *General rule.*—The sum of the years-digits method may be applied to group, classified, or composite accounts in accordance with the plan described in subparagraph (2) of this paragraph or in accordance with other plans as explained in subparagraph (3) of this paragraph.

(2) *Remaining life plan.*—The remaining life plan is applied to a single asset is described in paragraph (a) (2) of § 1.167(b)–3. This plan may also be applied to group, classified, or composite accounts. Under this plan the allowance for depreciation is computed by applying changing fractions to the unrecovered cost or other basis of the account reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the account (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the years digits corresponding to the years of estimated remaining useful life of the account. Decimal equivalents of such fractions can be obtained by use of Table I under paragraph (a) (2) (ii) of § 1.167(b)–3. The proper application of this method requires that the estimated remaining useful life of the account be determined each year. This determination, of course, may be made each year by analysis, i. e., by determining the remaining lives for each of the components in the account, and averaging them. The estimated remaining life of any account, however, may also be determined arithmetically. For example, it may be computed by dividing the unrecovered cost or other basis of the account, as computed by straight line depreciation, by the gross cost or other basis

of the account, and multiplying the result by the average life of the assets in the account. Salvage value is not a factor for the purpose of determining remaining life. Thus, if a group account with an average life of ten years had at January 1, 1958, a gross asset balance of $12,600 and a depreciation reserve computed on the straight line method of $9,450, the remaining life of the account at January 1, 1958, would be computed as follows:

$$\frac{\$12{,}600-\$9{,}450}{\$12{,}600} \text{ times 10 years equals 2.50 years.}$$

(i) *Example.* The use of the sum of the years-digits method with group, classified, or composite accounts under the remaining life plan is illustrated by the following example: A calendar year taxpayer maintains a group account to which a five-year life is applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of § 1.167(b)–1(b).

Depreciation computations on a group account under remaining life plan

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
											Sum of the years-digits depreciation			
Year	Asset balance Jan. 1	Current additions	Current retirements	Average asset balance	Straight line amount	Straight line reserve	Remaining life	Asset balance reduced by salvage	Current additions reduced by salvage	Salvage realized	Accumulated reserve Jan. 1	Unrecovered Jan. 1	Rate based on Col. (7) from table I	Allowable depreciation
					Col. (4) ÷ life	Col. (5) − Col. (3) accumulated Jan. 1	[Col. (1) − Col. (6) ÷ Col. (1)] × average service life	Col. (1) × (100% − 6.67%)	Col. (2) × (100% − 6.67%)		Prior reserve + Col. (14) + Col. (10) − Col. (3)	Col. (8) − Col. (11)		Col. (12) × Col. (13) + ½ Col. (9) × F [1]
1954		$12,000		$6,000	[2] $1,200		5.00		$11,200				0.3333	$1,866
1955	$12,000			12,000	2,400	$1,200	4.50	$11,200			$1,866	$9,334	.3600	3,360
1956	12,000			12,000	2,400	3,600	3.50	11,200			5,226	5,974	.4375	2,614
1957	12,000		$2,000	11,000	2,200	6,000	2.50	11,200		$200	7,840	3,360	.5556	1,867
1958	10,000		2,000	9,000	1,800	6,200	1.90	9,333		200	7,907	1,426	.6786	968
1959	8,000	10,000	4,000	11,000	2,200	6,000	1.25	7,466	9,333	400	7,075	391	.8125	1,874
1960	14,000		2,000	13,000	2,600	4,200	3.50	13,066			5,349	7,717	.4375	3,376
1961	12,000		2,000	11,000	2,200	4,800	3.00	11,200			6,725	4,475	.5000	2,238
1962						5,000					6,963			

[1] F = Rate based on average service life (0.3333 in this example).

[2] ½ year's amount.

(3) *Other plans for application of the sum of the years-digits method.*—Taxpayers who wish to use the sum of the years-digits method in computing depreciation for group, classified, or composite accounts in accordance with a sum of the years-digits plan other than the remaining life plan described herein may do so only with the consent of the Commissioner. Request for permission to use plans other than that described shall be addressed to the Commissioner of Internal Revenue, Washington 25, D. C.

§ 1.167(b)-4 OTHER METHODS.—(a) Under section 167(b)(4) a taxpayer may use any consistent method of computing depreciation, such as the sinking fund method, provided depreciation allowances computed in accordance with such method do not result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which could have resulted from the use of the declining balance method described in section 167(b)(2). This limitation applies only during the first two-thirds of the useful life of the property. For example, an asset costing $1,000 having a useful life of six years may be depreciated under the declining balance method in accordance with § 1.167(b)-2, at a rate of 33⅓ percent. During the first four years or ⅔ of its useful life, maximum depreciation allowances under the declining balance method would be as follows:

	Current depreciation	*Accumulated depreciation*	*Balance*
Cost of asset	--------	--------	$1,000
1st year	$333	$333	667
2d year	222	555	445
3d year	148	703	297
4th year	99	802	198

An annual allowance computed by any other method under section 167(b)(4) could not exceed $333 for the first year, and at the end of the second year the total allowances for the two years could not exceed $555. Likewise, the total allowances for the three years could not exceed $703 and for the four years could not exceed $802. This limitation would not apply in the fifth and sixth years. See section 167(c) and § 1.167(c)-1 for restrictions on the use of certain methods.

(b) It shall be the responsibility of the taxpayer to establish to the satisfaction of the Commissioner that a method of depreciation under section 167(b)(4) is both a reasonable and consistent method and that it does not produce depreciation allowances in excess of the amount permitted under the limitations provided in such section.

§ 1.167(c) STATUTORY PROVISIONS; DEPRECIATION; LIMITATIONS ON USE OF CERTAIN METHODS AND RATES.

SEC. 167. DEPRECIATION. * * *

(c) LIMITATIONS ON USE OF CERTAIN METHODS AND RATES.—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

(1) the construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

(2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

§ 1.167(c)–1 Limitations on Methods of Computing Depreciation Under Section 167(b)(2), (3), and (4).—(a) *In general.*—(1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167(b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For the purpose of the preceding sentence, property shall be deemed to be acquired when reduced to physical possession, or control. The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired after December 31, 1953, will not be treated as being put to original use by the taxpayer even though it is put to a different use, nor will a horse acquired for breeding purposes be treated as being put to original use by the taxypayer if prior to the purchase the horse was used for racing purposes. See §§ 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 for application of the various methods.

(3) Assets having an estimated average useful life of less than three yeras shall not be included in a group, classified, or composite account to which the methods described in §§ 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 are applicable. However, an incidental retirement of an asset from such an account prior to the expiration of a useful life of three years will not prevent the application of these methods to such an account.

(4) See section 381(c)(6) and the regulations thereunder for rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions.

(5) See section 1502 and § 1.1502–46 for the rule covering depreciation of property received by a member of an affiliated group from another member of the group during a consolidated return period.

(6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§ 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 are not applicable to property in the hands of a distributee, vendee, transferee, donee, or grantee unless the original use of the property begins with such person and the conditions required by section 167(c) and this section are otherwise met. For example, these methods of depreciation may not be used by a corporation with respect to property which it acquires from an individual or partnership in exchange for its stock. Similarly, if an individual or partnership receives property in a distribution upon dissolution of a corporation, these methods of depreciation may not be used with respect to property so acquired by such individual or partnership. As a further example, these methods of depreciation may not be used by a partnership with respect to contributed property, nor by a partner with respect to partnership property distributed to him. Moreover, where a partnership is entiled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase, and (ii) in the case of a decrease in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

(b) *Illustrations.*—(1) The application of these methods to property constructed, reconstructed, or erected by the taxpayer after December 31, 1953, may be illustrated by the following examples:

Example (1). If a building with a total cost of $100,000 is completed after December 31, 1953, and the portion attributable to construction after December 31, 1953, is determined by engineering estimates or by cost accounting records to be $30,000, the methods referred to in paragraph (a)(1) above, are applicable only to the $30,000 portion of the total.

Example (2). In 1954, a taxpayer has an old machine with an unrecovered cost of $1,000. If he contracts to have it reconditioned, or reconditions it himself, at a cost of an additional $5,000, only the $5,000 may be depreciated under the methods referred to in paragraph (a)(1) above, whether or not the materials used for reconditioning are new in use.

Example (3). A taxpayer who acquired a building in 1940 makes major maintenance or repair expenditures in 1954 of a type which must be capitalized. For these expenditures the taxpayer may use a method of depreciation different from that used on the building (for example, the methods referred to in paragraph (a)(1) above) only if he accounts for such expenditures separately from the account which contained the original building. In such case, the unadjusted basis on any parts replaced shall be removed

from the asset account and shall be charged to the appropriate depreciation reserve account. In the alternative he may capitalize such expenditures by charging them to the depreciation reserve account for the building.

(2) The application of these methods to property which was not constructed, reconstructed, or erected by the taxpayer but which was acquired after December 31, 1953, may be illustrated by the following examples:

Example (1). A taxpayer contracted in 1953 to purchase a new machine which he acquired in 1954 and put into first use in that year. He may use the methods referred to in paragraph (a)(1) above, in recovering the cost of the new machine.

Example (2). A taxpayer instead of reconditioning his old machine buys a "factory reconditioned" machine in 1954 to replace it. He cannot apply the methods referred to in paragraph (a)(1) above, to any part of the cost of the reconditioned machine since he is not the first user of the machine.

Example (3). In 1954, a taxpayer buys a house for $20,000 which had been used as a personal residence and thus had not been subject to depreciation allowances. He makes a capital addition of $5,000 and rents the property to another. The taxpayer may use the methods referred to in paragraph (a)(1) above, only with respect to the $5,000 cost of the addition.

(c) *Election to use methods.*—Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167(b)(2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) of this section, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167(b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

§ 1.167(d) Statutory Provisions; Depreciation; Agreement as to Useful Life on Which Depreciation Rate Is Based.

SEC. 167. DEPRECIATION. * * *

(d) Agreement as to Useful Life on Which Depreciation Rate Is Based.—Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of this title, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agree-

ment shall not be effective for taxable years before the taxable year in which notice in writing by registered mail is served by the party to the agreement initiating such change.

§ 1.167(d)-1 AGREEMENT AS TO USEFUL LIFE AND RATES OF DEPRECIATION.—After August 16, 1954, a taxpayer may, for taxable years ending after December 31, 1953, enter into an agreement with respect to the estimated useful life, method and rate of depreciation, and treatment of salvage of any property which is subject to the allowance for depreciation. An application for such agreement may be made to the district director of internal revenue for the district in which the taxpayer's return is required to be filed. Such application shall be filed in quadruplicate and shall contain in such detail as may be practical the following information:

(a) The character and location of the property.

(b) The original cost or other basis and date of acquisition.

(c) Proper adjustments to the basis including depreciation accumulated to the first taxable year to be covered by the agreement.

(d) Estimated useful life and estimated salvage value.

(e) Method and rate of depreciation.

(f) Any other facts and circumstances pertinent to making a reasonable estimate of the useful life of the property and its salvage value.

The agreement must be in writing and must be signed by the taxpayer and by the district director. The agreement must be signed in quadruplicate, and two of the signed copies will be returned to the taxpayer. The agreement shall set forth its effective date, the estimated remaining useful life, the estimated salvage value, and rate and method of depreciation of the property and the facts and circumstances taken into consideration in adoption of the agreement, and shall relate only to depreciation allowances for such property on and after the effective date of the agreement. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. Any change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life and rate, is sent by registered mail by the party proposing the change to the other party. A copy of the agreement (and any modification thereof) shall be filed with the taxpayer's return for the first taxable year which is affected by the agreement (or any modification thereof). A signed copy should be retained with the permanent records of the taxpayer. For rules relating to changes in method of depreciation, see § 1.167(e)-1 and section 446 and the regulations thereunder.

§ 1.167(e) STATUTORY PROVISIONS; DEPRECIATION; CHANGE IN METHOD.

SEC. 167. DEPRECIATION. * * *

(e) CHANGE IN METHOD.—In the absence of an agreement under subsection (d) containing a provision to the contrary, a taxpayer may at any time elect

in accordance with regulations prescribed by the Secretary or his delegate to change from the method of depreciation described in subsection (b)(2) to the method described in subsection (b)(1).

§ 1.167(e)-1 CHANGE IN METHOD.—(a) *In general.*—Any change in the method of computing the depreciation allowances with respect to a particular account is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that the change from the declining balance method to the straight line method as provided in section 167(e) shall be permitted without consent. See paragraph (b) of this section. A change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in § 1.167(a)-7. Any change in the percentage of the current straight line rate under the declining balance method, as for example, from 200% of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method will constitute a change in method of depreciation and will require the consent of the Commissioner. Any request for a change in method of depreciation shall be made in accordance with section 446 and the regulations thereunder and shall state the character and location of the property, method of depreciation being used and the method proposed, the date of acquisition, the cost or other basis and adjustments thereto, amounts recovered through depreciation and other allowances, the estimated salvage value, the estimated remaining life of the property, and such other information as may be required. For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations thereunder.

(b) *Declining balance to straight line.*—In the case of an account to which the method described in section 167(b)(2) is applicable, a taxpayer may change without the consent of the Commissioner, from the declining balance method of depreciation to the straight line method at any time during the useful life of the property under the following conditions. Such a change may not be made if a provision prohibiting such a change is contained in an agreement under section 167(d). When the change is made, the unrecovered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. With respect to any account, this change will be permitted only if applied to all the assets in the account as defined in § 1.167(a)-7. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the remaining useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. A change to the straight line method must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

§ 1.167(f) Statutory Provisions; Depreciation; Basis for Depreciation.

SEC. 167. DEPRECIATION. * * *

(f) Basis for Depreciation.—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

§ 1.167(f)–1 Basis for Depreciation.—The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

§ 1.167(g) Statutory Provisions; Depreciation; Life Tenants and Beneficiaries of Trusts and Estates.

SEC. 167. DEPRECIATION. * * *

(g) Life Tenants and Beneficiaries of Trusts and Estates.—In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

§ 1.167(g)–1 Life Tenants and Beneficiaries of Trusts and Estates.—(a) *Life tenants.*—In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(b) *Trusts.*—If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

(c) *Estates.*—In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate which is allocable to each.

§ 1.167(h) Statutory Provisions; Depreciation; Depreciation of Improvements in the Case of Mines, etc.

SEC. 167. DEPRECIATION. * * *

(h) Depreciation of Improvements in the Case of Mines, etc.—For additional rule applicable to depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber, see section 611.

§ 1.167(h)-1 Depreciation of Improvements in the Case of Mines, etc.—Property used in the trade or business or held for the production of income which is subject to the allowance for depreciation provided in section 611 shall be treated for all purposes of the Internal Revenue Code of 1954 as if it were property subject to the allowance for depreciation under section 167. The preceding sentence shall not limit the allowance for depreciation otherwise allowable under section 611.

§ 1.172. Statutory Provisions; Net Operating Loss Deduction.

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) Deduction Allowed.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net Operating Loss Carrybacks and Carryovers.—

(1) Years to which loss may be carried.—A net operating loss for any taxable year ending after December 31, 1953, shall be—

(A) a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(B) a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss.

(2) Amount of carrybacks and carryovers.—Except as provided in subsection (f), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the 7 taxable years to which (by reason of subparagraphs (A) and (B) of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other 6 taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding

sentence, the taxable income for any such prior taxable year shall be computed—

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (6) thereof; and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter, and the taxable income so computed shall not be considered to be less than zero.

(c) Net Operating Loss Defined.—For purposes of this section, the term "net operating loss" means (for any taxable year ending after December 31, 1953) the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

(d) Modifications.—The modifications referred to in this section are as follows:

(1) Net operating loss deduction.—No net operating loss deduction shall be allowed.

(2) Capital gains and losses of taxpayers other than corporations.—In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets; and

(B) the deduction for long-term capital gains provided by section 1202 shall not be allowed.

(3) Deduction for personal exemptions.—No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

(4) Nonbusiness deductions of taxpayers other than corporations.—In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business, shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2) (B), and (3) shall be taken into account; and

(C) any deduction allowable under section 165 (c) (3) (relating to casualty losses) shall not be taken into account.

(5) Special deductions for corporations.—No deduction shall be allowed under section 242 (relating to partially tax-exempt interest) or under section 922 (relating to Western Hemisphere trade corporations).

(6) Computation of deduction for dividends received, etc.—The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions); and the deduction allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities) shall be computed without regard to subsection (a) (1) (B) of such section.

(e) Law Applicable to Computations.—In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year. The preceding sentence shall apply with respect to all taxable years, whether they begin before, on, or after January 1, 1954.

(f) Taxable Years Beginning in 1953 and Ending in 1954.—In the case of a taxable year beginning in 1953 and ending in 1954—

(1) In lieu of the amount specified in subsection (c), the net operating loss for such year shall be the sum of—

(A) that portion of the net operating loss for such year computed without regard to this subsection which the number of days in the loss year after December 31, 1953, bears to the total number of days in such year, and

(B) that portion of the net operating loss for such year computed under section 122 of the Internal Revenue Code of 1939 as if this section had not been enacted which the number of days in the loss year before January 1, 1954, bears to the total number of days in such year.

(2) The amount of any net operating loss for such year which shall be carried to the second preceding taxable year is the amount which bears the same ratio to such net operating loss as the number of days in the loss year after December 31, 1953, bears to the total number of days in such year. In determining the amount carried to any other taxable year, the reduction for the second taxable year preceding the loss year shall not exceed the portion of the net operating loss which is carried to the second preceding taxable year.

(g) Special Transitional Rules.—

(1) Losses for taxable years ending before January 1, 1954.—For purposes of this section, the determination of the taxable years ending after December 31, 1953, to which a net operating loss for any taxable year ending before January 1, 1954, may be carried shall be made under the Internal Revenue Code of 1939.

(2) Losses for taxable years ending after December 31, 1953.—For purposes of section 122 of the Internal Revenue Code of 1939—

(A) the determination of the taxable years ending before January 1, 1954, to which a net operating loss for any taxable year ending after December 31, 1953, may be carried shall be made under subsection (b) (1) (A) of this section; and

(B) in determining the amount of the carryback to the first taxable year preceding the first taxable year ending after December 31, 1953, the portion of the net operating loss carried to such year shall be such net operating loss reduced by—

(i) the net income for the second preceding taxable year computed as if the second sentence of section 122(b) (2) (B) of the Internal Revenue Code of 1939 applied, or

(ii) if smaller, the portion of the net operating loss which by reason of subsection (f) of this section is carried to the second preceding taxable year.

(3) Excess profits tax not affected.—For purposes of subchapter D of chapter 1 of the Internal Revenue Code of 1939, excess profits net income shall be computed as if this section had not been enacted and as if section 122 of such Code continued to apply to taxable years to which this subtitle applies.

(h) Cross References.—

(1) For treatment of net operating loss carryovers in certain corporate acquisitions, see section 381.

(2) For special limitation on net operating loss carryovers in case of a corporate change of ownership, see section 382.

§ 1.172–1 Net Operating Loss Deduction.—(a) *Allowance of deduction.*—Section 172(a) allows as a deduction in computing taxable income for any taxable years subject to the 1954 Code the aggregate of the net operating loss carryovers and net operating loss carrybacks to such taxable year. This deduction is referred to as the net operating loss deduction. The net operating loss is the basis for the computation of the net operating loss carryovers and net operating loss carrybacks and ultimately for the net operating loss deduction itself. The net operating loss deduction shall not be disallowed for any taxable year merely because the taxpayer has no income from a trade or business for the taxable year.

(b) *Steps in computation of net operating loss deduction.*—The three steps to be taken in the ascertainment of the net operating loss deduction for any taxable year subject to the 1954 Code are as follows:

(1) Compute the net operating loss for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to such taxable year.

(2) Compute the net operating loss carryovers to such taxable year from such preceding taxable years and the net operating loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such net operating loss carryovers and carrybacks in order to determine the net operating loss deduction for such taxable year.

(c) *Statement with tax return.*—Every taxpayer claiming a net operating loss deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction.

(d) *Ascertainment of deduction dependent upon net operating loss carryback.*—If the taxpayer is entitled in computing his net operating loss deduction to a carryback which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on his return without regard to such net operating loss carryback. When the taxpayer ascertains the net operating loss carryback, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carryback; or he may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations.*—(1) *General.*—The following rules shall apply to all taxable years without regard to whether they began before, on, or after January 1, 1954:

(i) In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(ii) The net operating loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the net operating loss deduction. In applying this rule, however, certain taxable years subject to the 1939 Code shall, to the extent provided in paragraphs (a) and (c) of § 1.172–2 and paragraphs (a) and (e) of § 1.172–3, be treated as though subject to the 1954 Code.

(iii) The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year.

(2) *Special transitional rules.*—For special transitional rules with respect to net operating losses sustained in taxable years ending before January 1, 1954, and in taxable years ending after December 31, 1953, see section 172(g).

(f) *Taxable years subject to 1939 Code.*—For the computation of the net operating loss deduction for any taxable year which is subject to the 1939 Code, see § 39.122–5 of Regulations 118 (26 CFR (1939) 39.122–5) or the corresponding section of prior applicable regulations.

§ 1.172–2 NET OPERATING LOSS IN CASE OF A CORPORATION.—(a) *Modification of deductions.*—A net operating loss is sustained by a corporation in any taxable year beginning after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the 1954 Code over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the 1939 Code. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.*—No deduction shall be allowed under—

(i) Section 172 for the net operating loss deduction,

(ii) Section 242 in respect of partially tax-exempt interest, and

(iii) Section 922 in respect of Western Hemisphere trade corporations;

(2) *Dividends received.*—The 85-percent limitation provided by section 246(b) shall not apply to the deductions otherwise allowed under—

(i) Section 243 in respect of dividends received from domestic corporations,

(ii) Section 244 in respect of dividends received on preferred stock of public utilities, and

(iii) Section 245 in respect of dividends received from foreign corporations; and

(3) *Dividends paid.*—The deduction granted by section 247 in respect of dividends paid on the preferred stock of public utilities shall be computed without regard to subsection (a)(1)(B) of that section.

(b) *Illustration of principles.*—The application of paragraph (a) of this section may be illustrated by the following example:

Example. For the calendar year 1954 the X Corporation has gross income of $400,000 and total deductions allowed by chapter 1 of the 1954 Code of $375,000, exclusive of any net operating loss deduction and exclusive of any deduction for dividends received or paid. Corporation X in 1954 received $100,000 of dividends entitled to the benefits of section 243. These dividends are included in Corporation X's $400,000 gross income. Corporation X likewise received $50,000 of partially tax-exempt interest in 1954 for which a deduction is allowed under section 242. This interest is included in both the $400,000 gross income and the $375,000 total deductions. Corporation X has no other deductions to which section 172(d) applies. On the basis of these facts, Corporation X has a net operating loss for the year 1954 of $10,000, computed as follows:

Deductions for 1954	$375,000
Plus: Deduction for dividends received, computed without regard to the limitation provided in section 246(b) (85% of $100,000)	85,000
Total	$460,000
Less: Deduction with respect to partially tax-exempt interest	50,000
Deductions modified as required by section 172(d)	$410,000
Less: Gross income for 1954 (including $100,000 dividends and $50,000 partially tax-exempt interest)	400,000
Net operating loss for 1954	$10,000

(c) *Taxable years beginning in 1953 and ending in 1954.*—The net operating loss of a corporation for a taxable year which begins in 1953 and ends in 1954 shall be the sum of—

(1) *Application of 1954 Code.*—That portion of the net operating loss for the taxable year, computed in accordance with paragraph (a) of this section as though such taxable year began after December 31, 1953, which the number of days in the taxable year after December 31, 1953, bears to the total number of days in the taxable year, and

(2) *Application of 1939 Code.*—That portion of the net operating loss for the taxable year, computed in accordance with section 122 of the 1939 Code and as though section 172 of the 1954 Code had not been enacted, which the number of days in the taxable year before January 1, 1954, bears to the total number of days in the taxable year.

(d) *Excess profits tax.*—For the computation of the net operating loss for purposes of determining the excess profits tax imposed by subchapter D of chapter 1 of the 1939 Code, see § 1.172–8.

§ 1.172–3 Net Operating Loss in Case of a Taxpayer Other Than a Corporation.—(a) *Modification of deductions.*—A net operating loss is sustained by a taxpayer other than a corporation in any taxable year beginning after December 31, 1953, if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the 1954 Code over gross income computed thereunder; this rule shall apply even though the loss year is otherwise subject to the 1939 Code. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.*—No deduction shall be allowed under—

(i) Section 151 for the personal exemptions or under any other section which grants a deduction in lieu of the deductions allowed by section 151,

(ii) Section 172 for the net operating loss deduction, and

(iii) Section 1202 in respect of the net long-term capital gain.

(2) *Capital losses.*—(i) The amount deductible on account of business capital losses shall not exceed the sum of the amount includible on account of business capital gains and that portion of nonbusiness capital gains which is computed in accordance with paragraph (c) of this section.

(ii) The amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains.

(3) *Nonbusiness deductions.*—(i) *Ordinary deductions.*—Ordinary nonbusiness deductions shall be taken into account without regard to the amount of business deductions and shall be allowed in full to the extent, but not in excess, of that amount which is the sum of the ordinary nonbusiness gross income and the excess of nonbusiness capital gains over nonbusiness capital losses. See paragraph (c)(3) of this section. For purposes of section 172, nonbusiness deductions and income are those deductions and that income which are not attributable to, or derived from, a taxpayer's trade or business. Wages and salary constitute income attributable to the taxpayer's trade or business for such purposes.

(ii) *Sale of business property.*—Any gain or loss on the sale or other disposition of property which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposes of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business. Such gains and losses are to be taken into account fully in computing a net operating loss without regard to the limitation on nonbusiness deductions. Thus, a farmer who sells at a loss land used in the business of farming may, in computing a net operating loss, include in full the deduction otherwise allowable with respect to such loss, without regard to the amount of his nonbusiness income and without regard to whether he is engaged in the trade or business of selling farms. Similarly, an individual who sells at a loss machinery which is used in his trade or business and which is of a character that is subject to the allowance for depreciation may, in computing the net operating loss, include in full the deduction otherwise allowable with respect to such loss.

(iii) *Casualty losses.*—Any deduction allowable under section 165(c)(3) for losses of property not connected with a trade or business shall not be considered, for purposes of section 172(d)(4), to be a nonbusiness deduction but shall be treated as a deduction attributable to the taxpayer's trade or business.

(iv) *Limitation.*—The provisions of this subparagraph shall not be construed to permit the deduction of items disallowed by subparagraph (1) of this paragraph.

(b) *Treatment of capital loss carryovers.*—Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has a capital loss carryover from preceding taxable years, includible by virtue of section 1212 among the short-term capital losses for the taxable year in issue, is required to determine how much of such capital loss carryover is a business capital loss and how much is a nonbusiness capital loss. In order to make this determination, the taxpayer shall first ascertain what proportion of the net capital loss for each of such preceding taxable years was attributable to an excess of business capital losses over business capital gains for such year, and what proportion was attributable to an excess of nonbusiness

capital losses over nonbusiness capital gains. The same proportion of the capital loss carryover from any such preceding taxable year shall be treated as a business capital loss and a nonbusiness capital loss, respectively. This rule may be illustrated by the following example:

Example. (1) A, an individual, has $5,000 ordinary taxable income (computed without regard to the deductions for personal exemptions) for the calendar year 1954 and also has the following capital gains and losses for such year: Business capital gains of $2,000; business capital losses of $3,200; nonbusiness capital gains of $1,000; and nonbusiness capital losses of $1,200.

(2) A's net capital loss for the taxable year 1954 is $400, computed as follows:

Capital losses	$4,400
Capital gains	3,000
Excess of capital losses over capital gains	$1,400
Less: $1,000 of such ordinary taxable income	1,000
Net capital loss for 1954	$400

(3) A's capital losses for 1954 exceeded his capital gains for such year by $1,400. Since A's business capital losses for 1954 exceeded his business capital gains for such year by $1,200, six-sevenths ($1,200/$1,400) of A's net capital loss for 1954 is attributable to an excess of his business capital losses over his business capital gains for such year. Similiarly, one-seventh of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the capital loss carryover from 1954 to 1955 is $400, six-sevenths of $400, or $342.86, shall be treated as a business capital loss in 1955; and one-seventh of $400, or $57.14, as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses.*—In the computation of a net operating loss a taxpayer other than a corporation must use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. Any amount not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. The remainder, computed by applying the excess ordinary nonbusiness deductions against the excess nonbusiness capital gains, shall be treated as nonbusiness capital gains and used for the purpose of determining the deductibility of business capital losses under paragraph (a) (2) (i) of this section. This principle may be illustrated by the following example:

Example. (1) A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Capital gains	13,000
Total gross income	$20,500

(2) A also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Capital loss	7,000
Total deductions	$16,000

(3) The portion of nonbusiness capital gains to be used for the purpose of determining the deductibility of business capital losses is $4,500, computed as follows:

Nonbusiness capital gains		$13,000
Less: Nonbusiness capital loss		7,000
Excess to be taken into account for purposes of paragraph (a)(3)(i) of this section		$6,000
Ordinary nonbusiness deductions	$9,000	
Less: Ordinary nonbusiness gross income	7,500	
		1,500
Portion of nonbusiness capital gains to be used for purposes of paragraph (a)(2)(i) of this section		$4,500

(d) *Joint net operating loss of husband and wife.*—In the case of a husband and wife, the joint net operating loss for any taxable year for which a joint return is filed is to be computed on the basis of the combined income and deductions of both spouses, and the modifications prescribed in paragraph (a) of this section are to be computed as if the combined income and deductions of both spouses were the income and deductions of one individual.

(e) *Taxable years beginning in 1953 and ending in 1954.*—The net operating loss of a taxpayer other than a corporation for a taxable year which begins in 1953 and ends in 1954 shall be the sum of—

(1) *Application of 1954 Code.*—That portion of the net operating loss for the taxable year, computed in accordance with paragraph (a) of this section as though such taxable year began after December 31, 1953, which the number of days in the taxable year after December 31, 1953, bears to the total number of days in the taxable year, and

(2) *Application of 1939 Code.*—That portion of the net operating loss for the taxable year, computed in accordance with section 122 of the 1939 Code and as though section 172 of the 1954 Code had not been enacted, which the number of days in the taxable year before January 1, 1954, bears to the total number of days in the taxable year.

(f) *Illustration of computation of net operating loss of a taxpayer other than a corporation.*—(1) *Facts.*—For the calendar year 1954, A, an individual, has gross income of $483,000 and allowable deductions of $540,000. The latter amount does not include the net operating loss deduction or any deduction on account of the sale or exchange of capital assets. Included in gross income are business capital gains of $50,000 and ordinary nonbusiness income of $10,000. Included among the deductions are ordinary nonbusiness deductions of $12,000 and a deduction of $600 for his personal exemption. A has a business capital loss of $60,000 in 1954. A has no other items of income or deductions to which section 172(d) applies.

(2) *Computation.*—On the basis of these facts, A has a net operating loss for 1954 of $104,400, computed as follows:

Deductions for 1954 (as specified in first sentence of subparagraph (1))		$540,000
Plus: Amount of business capital loss ($60,000) to extent such amount does not exceed business capital gains ($50,000)		50,000
Total		$590,000
Less:		
Excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income ($12,000 minus $10,000)	$2,000	
Deduction for personal exemption	600	
		$2,600
Deductions for 1954 adjusted as required by section 172(d)		$587,400
Gross income for 1954		483,000
Net operating loss for 1954		$104,400

§ 1.172–4 Net Operating Loss Carrybacks and Net Operating Loss Carryovers.—(a) *General provisions.*—(1) *Years to which loss may be carried.*—In order to compute the net operating loss deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. A net operating loss sustained in a taxable year ending after December 31, 1953, shall be carried back to the two preceding taxable years and carried over to the five succeeding taxable years; this rule shall apply even though the loss year is otherwise subject to the 1939 Code. A net operating loss sustained in a taxable year ending before January 1, 1954 (and beginning after December 31, 1949), shall be carried back to the first preceding taxable year and carried over to the five succeeding taxable years.

(2) *Periods of less than 12 months.*—A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 172 the first, second, etc., preceding or succeeding taxable year.

(3) *Amount of loss to be carried.*—The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(4) *Husband and wife.*—The net operating loss carryovers and carrybacks of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of § 1.172–7.

(5) *Excess profits tax.*—For the number of taxable years to which a net operating loss may be carried back for the purpose of determin-

ing the excess profits tax imposed by subchapter D of chapter 1 of the 1939 Code, see § 1.172–8.

(6) *Corporate acquisitions.*—For the computation of the net operating loss carryovers in the case of certain acquisitions of the assets of a corporation by another corporation, see section 381 and the regulations thereunder.

(7) *Special limitations.*—For special limitations on the net operating loss carryovers in certain cases of change in both the ownership and the trade or business of a corporation and in certain cases of corporate reorganization lacking specified continuity of ownership, see section 382 and the regulations thereunder.

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue.*—(1) *Manner of computation.*—(i) A net operating loss shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc. The entire net operating loss shall be carried back to such earliest year.

(ii) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the aggregate of the taxable incomes (computed as provided in § 1.172–5) for all of such several taxable years preceding such subsequent taxable year which are subject to the 1954 Code and the aggregate of the net incomes (computed as provided in § 39.122–4(c) of Regulations 118 (26 CFR (1939) 39.122–4(c)) or in the corresponding section of prior applicable regulations) for all of such preceding taxable years which are subject to the 1939 Code.

(2) *Taxable years beginning in 1953 and ending in 1954.*—(i) Notwithstanding subparagraph (1) of this paragraph, in the case of a net operating loss sustained in a taxable year which begins in 1953 and ends in 1954, the amount of such loss which shall be carried back to the second preceding taxable year is the amount which bears the same ratio to such net operating loss (computed as provided in § 1.172–2(c) or § 1.172–3(e), whichever applies) as the number of days in such loss year after December 31, 1953, bears to the total number of days in such year.

(ii) To determine the portion of the net operating loss for such a taxable year ending in 1954 which shall be carried to any taxable year subsequent to such second preceding taxable year there shall be substituted, in the application of subparagraph (1)(ii) of this paragraph, for the net income of such second preceding taxable year an amount equal to the portion of the net operating loss which is carried back to such second preceding taxable year in accordance with this subparagraph, if such amount is smaller than the net income of such second preceding taxable year as computed under § 29.122–4(c) of Regulations 111 (26 CFR (1939) 29.122–4(c)).

(3) *Excess profits tax.*—For the portion of a net operating loss which may be carried back from a taxable year ending after December 31, 1953, for the purpose of determining the excess profits tax imposed by subchapter D of chapter 1 of the 1939 Code, see § 1.172–8.

(4) *Illustration of principles.*—The application of this paragraph may be illustrated by the following examples:

Example (1). A taxpayer who makes his tax returns on the calendar-year basis has a net operating loss for 1954. The entire net operating loss for 1954 may be carried back to 1952. The amount of the carryback to 1953 is the excess of the 1954 loss over the net income for 1952. The amount of the carryover to 1955 is the excess of the 1954 loss over the aggregate of the net incomes for 1952 and 1953. The amount of the carryover to 1956 is the excess of the 1954 loss over the sum of the aggregate of the net incomes for 1952 and 1953 and the taxable income for 1955. Similarly, the amount of the carryovers to 1957, 1958, and 1959 is the excess of the 1954 loss over the sum of the aggregate of the net incomes for 1952 and 1953 and the aggregate of the taxable incomes for 1955 and 1956; for 1955, 1956, and 1957; and for 1955, 1956, 1957, and 1958, respectively. For such purposes, the net incomes for 1952 and 1953 shall be computed as provided in § 39.122–4(c) of Regulations 118 (26 CFR (1939) 39.122–4(c)), and the taxable incomes for 1955 through 1958 shall be computed as provided in § 1.172–5 of these regulations.

Example (2). (i) A taxpayer who makes his tax returns on the basis of a fiscal year ending June 30 has a net operating loss (computed as provided in § 1.172–3(e)) for the taxable year which begins July 1, 1953, and ends June 30, 1954. The amount of the carryback from such taxable year to the taxable year ending June 30, 1952, the second preceding taxable year, is 181/365ths of the net operating loss. If such amount is not less than the net income (computed as provided in § 29.122–4(c) of Regulations 111 (26 CFR (1939) 29.122–4(c))) for the taxable year ending June 30, 1952, the amount of the carryback to the taxable year which ends June 30, 1953, is the excess of the net operating loss over the net income so computed for the taxable year ending June 30, 1952. The carryovers to the taxable years ending June 30, 1955, 1956, 1957, 1958, and 1959 are computed in the same manner as in example (1).

(ii) If, however, the net income so computed for the taxable year ending June 30, 1952, exceeds the amount of the carryback to such taxable year (181/365ths of the net operating loss for the loss year), then the amount of the carryback to the taxable year ending June 30, 1953, is the excess of the net operating loss over the amount of the carryback to the taxable year ending June 30, 1952. In such instance, the amount of the carryover to the taxable year ending June 30, 1955, is the excess of the net operating loss over the sum of the amount of the carryback to the taxable year ending June 30, 1952, and the net income (computed as provided in § 39.122–4(c) of Regulations 118 (26 CFR (1939) 39.122–4(c))) for the taxable year ending June 30, 1953. The amount of the carryovers to the taxable years ending June 30, 1956, 1957, 1958, and 1959 is the excess of the net operating loss over the sum of the amount of the carryback to the taxable year ending June 30, 1952. the net income so computed for the taxable year ending June 30, 1953, and the aggregate of the taxable incomes (computed as provided in § 1.172–5) for the taxable years ending June 30, 1955; 1955

and 1956; 1955, 1956, and 1957; and 1955, 1956, 1957, and 1958, respectively.

(c) *Illustration.*—The principles of this section are illustrated in § 1.172–6.

§ 1.172–5 TAXABLE INCOME WHICH IS SUBTRACTED FROM NET OPERATING LOSS TO DETERMINE CARRYBACK OR CARRYOVER.—(a) *Taxable year subject to 1954 Code.*—The taxable income for any taxable year subject to the 1954 Code which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year is computed with the modifications prescribed in this paragraph. These modifications shall be made independently of, and without reference to, the modifications required by §§ 1.172–2(a) and 1.172–3(a) for purposes of computing the net operating loss itself.

(1) *Modifications applicable to corporations only.*—In the case of a corporation the deductions provided by section 242 (relating to partially tax-exempt interest) and by section 922 (relating to Western Hemisphere trade corporations) shall not be allowed.

(2) *Modifications applicable to unincorporated taxpayers only.*—In the case of a taxpayer other than a corporation, in computing taxable income and adjusted gross income—

(i) No deduction shall be allowed under section 151 for the personal exemptions (or under any other section which grants a deduction in lieu of the deductions allowed by section 151) and under section 1202 in respect of the net long-term capital gain.

(ii) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets.

(3) *Modifications applicable to all taxpayers.*—In the case either of a corporation or of a taxpayer other than a corporation—

(i) *Net operating loss deduction.*—The net operating loss deduction for such taxable year shall be computed by taking into account only such net operating losses otherwise allowable as carryovers or a carryback to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the taxable income is to be deducted. Thus, for such purposes the net operating loss for the loss year or for any taxable year thereafter shall not be taken into account.

Example. The taxpayer's income tax returns are made on the basis of the calendar year. In computing the net operating loss deduction for 1954, the taxpayer has a carryover from 1952 of $9,000, a carryover from 1953 of $6,000, a carryback from 1955 of $18,000, and a carryback from 1956 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the net operating loss deduction for 1954, for purposes of determining the tax liability for 1954, is $43,000. However, in computing the taxable income for 1954 which is subtracted from the net operating loss for

1955 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $15,000, that is, the aggregate of the $9,000 carryover from 1952 and the $6,000 carryover from 1953. In computing the net operating loss deduction for such purpose, the $18,000 carryback from 1955 and the $10,000 carryback from 1956 are disregarded. In computing the taxable income for 1954, however, which is subtracted from the net operating loss for 1956 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $33,000, that is, the aggregate of the $9,000 carryover from 1952, the $6,000 carryover from 1953, and the $18,000 carryback from 1955. In computing the net operating loss deduction for such purpose, the $10,000 carryback from 1956 is disregarded.

(ii) *Recomputation of percentage limitations.*—Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the taxable income or adjusted gross income, as the case may be, determined with the modifications prescribed in this paragraph. Thus, in the case of an individual the deduction for medical expenses would be recomputed after making all the modifications prescribed in this paragraph, whereas the deduction for charitable contributions would be determined without regard to any net operating loss carryback but with regard to any other modifications so prescribed.

Example (1). For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $4,800, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		$9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		$7,000
Less:		
Deduction for personal exemption	$600	
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3% of adjusted gross income)	200	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20% of adjusted gross income)	1,400	
		2,200
Taxable income		$4,800

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount

of the carryover of the 1956 loss to 1957 the taxable income for 1954 as computed under this paragraph is $3,970, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		$9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		$6,000
Less:		
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3% of adjusted gross income as modified under this paragraph)	$230	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20% of adjusted gross income determined with all the modifications prescribed in this paragraph other than the net operating loss carryback)	1,800	
		2,030
Taxable income		$3,970

Example (2). For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $5,700, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		$9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		$7,000
Less: Deduction for personal exemption	$600	
Standard deduction allowed by section 141	700	
		1,300
Taxable income		$5,700

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957 the taxable income for 1954 as computed under this paragraph is $5,400, determined as follows:

Salary	$5,000
Net long-term capital gain	4,000
Total gross income	$9,000
Less: Deduction for carryback of 1955 net operating loss	3,000
Adjusted gross income	$6,000
Less: Standard deduction allowed by section 141	600
Taxable income	$5,400

(iii) *Minimum limitation.*—The taxable income, as modified under this paragraph, shall in no case be considered less than zero.

(b) *Taxable year subject to 1939 Code.*—For the computation of the net income for any taxable year subject to the 1939 Code which is subtracted from the net operating loss for any other taxable year to determine the portion of such loss which is a carryback or a carryover to a particular taxable year, see § 39.122–4(c) of Regulations 118 (26 CFR (1939) 39.122–4(c)) or the corresponding section of prior applicable regulations.

§ 1.172–6 Illustration of Net Operating Loss Carrybacks and Carryovers.—The application of § 1.172–4 may be illustrated by the following example:

(a) *Facts.*—The books of the taxpayer, whose return is made on the basis of the calendar year, reveal the following facts:

Taxable year	*Net income*	*Taxable income*	*Net operating loss*
1952	$20,000		
1953			($75,000)
1954		$15,000	
1955		30,000	
1956			(150,000)
1957		20,000	
1958		10,000	
1959		30,000	
1960		35,000	
1961		75,000	

The taxable (and net) income thus shown are computed without any net operating loss deduction. The assumption is also made that none of the other modifications prescribed in § 39.122–4(c) of Regulations 118 (26 CFR (1939) 39.122–4(c)) and § 1.172–5 of these regulations apply. There are no net operating losses for 1949, 1950, 1951, 1962, or 1963.

(b) *Loss sustained in 1953.*—The portions of the $75,000 net operating loss for 1953 which shall be used as a carryback to 1952 and as carryovers to 1954, 1955, 1956, 1957, and 1958 are computed as follows:

(1) *Carryback to 1952.*—The carryback to this year is $75,000, that is, the amount of the net operating loss.

(2) *Carryover to 1954.*—The carryover to this year is $55,000, computed as follows:

Net operating loss	$75,000
Less: Net income for 1952 (computed without the deduction of the carryback from 1953)	20,000
Balance	$55,000

(3) *Carryover to 1955.*—The carryover to this year is $40,000, computed as follows:

Net operating loss		$75,000
Less: Net income for 1952 (computed without the deduction of the carryback from 1953)	$20,000	
Taxable income for 1954 (computed without the deduction of the carryover from 1953 or the carryback from 1956)	15,000	
		35,000
Balance		$40,000

(4) *Carryover to 1956.*—The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Net income for 1952 (computed without the deduction of the carryback from 1953)	$20,000	
Taxable income for 1954 (computed without the deduction of the carryover from 1953 or the carryback from 1956)	15,000	
Taxable income for 1955 (computed without the deduction of the carryover from 1953 or the carryback from 1956)	30,000	
		65,000
Balance		$10,000

(5) *Carryover to 1957.*—The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Net income for 1952 (computed without the deduction of the carryback from 1953)	$20,000	
Taxable income for 1954 (computed without the deduction of the carryover from 1953 or the carryback from 1956)	15,000	
Taxable income for 1955 (computed without the deduction of the carryover from 1953 or the carryback from 1956)	30,000	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
		65,000
Balance		$10,000

(6) *Carryover to 1958.*—There is no carryover to this year of the net operating loss from 1953 since such loss does not exceed $85,000, the sum of the net income for 1952 and the taxable incomes of the first four taxable years following 1953. This $85,000 total consists of the $20,000 net income for 1952, the $15,000 taxable income for 1954, the $30,000 taxable income for 1955, and the $20,000 taxable income for 1957, computed without a net operating loss deduction for any such taxable years since the carryback and carryovers from 1953 (the year of the net operating loss) and the carrybacks and carryover from 1956 (a year subsequent to the year of the net operating loss) are not taken into account.

(c) *Loss sustained in 1956.*—The portions of the $150,000 net operating loss for 1956 which shall be used as carrybacks to 1954 and 1955 and as carryovers to 1957, 1958, 1959, 1960, and 1961 are computed in this paragraph. The amount specified in such computation with respect to a designated taxable year as the carryover to such year of the 1953 net operating loss is the amount computed for such year under paragraph (b) of this section.

(1) *Carryback to 1954.*—The carryback to this year is $150,000, that is, the amount of the net operating loss.

(2) *Carryback to 1955.*—The carryback to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less: Taxable income for 1954 (the $15,000 taxable income for such year reduced by the carryover to such year of $55,000 from 1953, the carryback from 1956 to 1954 not being taken into account)		0
Balance		$150,000

(3) *Carryover to 1957.*—The carryover to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1954 (the $15,000 taxable income for such year reduced by the carryover to such year of $55,000 from 1953, the carryback from 1956 to 1954 not being taken into account)	$0	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryover to such year of $40,000 from 1953, the carryback from 1956 to 1955 not being taken into account)	0	
		0
Balance		$150,000

(4) *Carryover to 1958.*—The carryover to this year is $140,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1954 (the $15,000 taxable income for such year reduced by the carryover to such year of $55,000 from 1953, the carryback from 1956 to 1954 not being taken into account)	$0	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryover to such year of $40,000 from 1953, the carryback from 1956 to 1955 not being taken into account)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1953, the carryover from 1956 to 1957 not being taken into account)	10,000	
		10,000
Balance		$140,000

(5) *Carryover to 1959.*—The carryover to this year is $130,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1954 (the $15,000 taxable income for such year reduced by the carryover to such year of $55,000 from 1953, the carryback from 1956 to 1954 not being taken into account)	$0	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carry-		

416926°—57——12

over to such year of $40,000 from 1953, the carryback from 1956 to 1955 not being taken into account)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1953, the carryover from 1956 to 1957 not being taken into account)	10, 000	
Taxable income for 1958 (the $10,000 taxable income for such year reduced by the carryover to such year of $0 from 1953, the carryover from 1956 to 1958 not being taken into account)	10, 000	
		20, 000
Balance		$130, 000

(6) *Carryover to 1960.*—The carryover to this year is $100,000, computed as follows:

Net operating loss		$150, 000
Less:		
Taxable income for 1954 (the $15,000 taxable income for such year reduced by the carryover to such year of $55,000 from 1953, the carryback from 1956 to 1954 not being taken into account)	$0	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryover to such year of $40,000 from 1953, the carryback from 1956 to 1955 not being taken into account)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1953, the carryover from 1956 to 1957 not being taken into account)	10, 000	
Taxable income for 1958 (the $10,000 taxable income for such year reduced by the carryover to such year of $0 from 1953, the carryover from 1956 to 1958 not being taken into account)	10, 000	
Taxable income for 1959 (computed without the deduction of the carryover from 1956)	30, 000	
		50, 000
Balance		$100, 000

(7) *Carryover to 1961.*—The carryover to this year is $65,000, computed as follows:

Net operating loss		$150, 000
Less:		
Taxable income for 1954 (the $15,000 taxable income for such year reduced by the carryover to such year of $55,000 from 1953, the carryback from 1956 to 1954 not being taken into account)	$0	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryover to such year of $40,000 from 1953, the carryback from 1956 to 1955 not being taken into account)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carry-		

over to such year of $10,000 from 1953, the carryover from 1956 to 1957 not being taken into account)	10,000	
Taxable income for 1958 (the $10,000 taxable income for such year reduced by the carryover to such year of $0 from 1953, the carryover from 1956 to 1958 not being taken into account)	10,000	
Taxable income for 1959 (computed without the deduction of the carryover from 1956)	30,000	
Taxable income for 1960 (computed without the deduction of the carryover from 1956)	35,000	
		85,000
Balance		$65,000

(d) *Determination of net operating loss deduction for each year.*—The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the net operating loss deduction in the manner prescribed in this paragraph. For this purpose the assumption is made that the application of § 39.122–5 of Regulations 118 (26 CFR (1939) 39.122–5) does not cause any reduction of the amount of the net operating loss carryback to 1952, so that such carryback is the net operating loss deduction for such year.

Taxable year	*Carryover*		*Carryback*		*Net operating loss deduction*
	From 1953	*From 1956*	*From 1953*	*From 1956*	
1952			$75,000		$75,000
1954	$55,000			$150,000	205,000
1955	40,000			150,000	190,000
1957	10,000	$150,000			160,000
1958	0	140,000			140,000
1959		130,000			130,000
1960		100,000			100,000
1961		65,000			65,000

§ 1.172–7 JOINT RETURN BY HUSBAND AND WIFE.—(a) *In general.*—This section prescribes additional rules for computing the net operating loss carrybacks and carryovers of a husband and wife making a joint return for one or more of the taxable years involved in the computation of the net operating loss deduction. If any one or more of the taxable years involved in the computation of such net operating loss carrybacks and carryovers is a taxable year subject to the 1939 Code, see also § 39.122–4(e) of Regulations 118 (26 CFR (1939) 39.122–4(e)) or the corresponding section of prior applicable regulations.

(b) *From separate to joint return.*—If a husband and wife, making a joint return for any taxable year, did not make a joint return for any of the taxable years involved in the computation of a net operating loss carryover or a net operating loss carryback to the taxable year for which the joint return is made, such separate net operating loss carryover or separate net operating loss carryback is a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(c) *Continuous use of joint return.*—If a husband and wife making a joint return for a taxable year made a joint return for each of the

taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the joint net operating loss carryover or joint net operating loss carryback to such taxable year is computed in the same manner as the net operating loss carryover or net operating loss carryback of an individual under § 1.172-4 but upon the basis of the joint net operating losses and the combined taxable income of both spouses.

(d) *From joint to separate return.*—If a husband and wife making separate returns for a taxable year made a joint return for any, or all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the separate net operating loss carryover or separate net operating loss carryback of each spouse to the taxable year is computed in the manner set forth in § 1.172-4 but with the following modifications:

(1) *Net operating loss.*—The net operating loss of each spouse for a taxable year for which a joint return was made shall be deemed to be that portion of the joint net operating loss (computed in accordance with paragraph (d) of § 1.172-3) which is attributable to the gross income and deductions of such spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing the joint net operating loss.

(2) *Taxable income to be subtracted.*—(i) *Net operating loss of other spouse.*—The taxable income of a particular spouse for any taxable year which is subtracted from the net operating loss of such spouse for another taxable year in order to determine the amount of such loss which may be carried back or carried over to still another taxable year is deemed to be, in a case in which such taxable income was reported in a joint return, the sum of the following:

(*a*) That portion of the combined taxable income of both spouses for such year for which the joint return was made which is attributable to the gross income and deductions of the particular spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing such combined taxable income, and

(*b*) That portion of such combined taxable income which is attributable to the other spouse; but, if such other spouse sustained a net operating loss in a taxable year beginning on the same date as the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted, then such portion shall first be reduced by such net operating loss of such other spouse.

(ii) *Modifications.*—For purposes of this subparagraph, the combined taxable income shall be computed as though the combined income and deductions of both spouses were those of one individual. The provisions of § 1.172-5 shall apply in computing the combined taxable income for such purposes except that the net operating loss deduction shall be determined without taking into account any separate net operating loss of either spouse, or any joint net operating loss of both spouses, which was sustained in a taxable year beginning on or after the date of the beginning of the taxable year in

which the particular spouse sustained the net operating loss from which the taxable income is subtracted.

(e) *Recurrent use of joint return.*—If a husband and wife making a joint return for any taxable year made a joint return for one or more, but not all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, such net operating loss carryover or net operating loss carryback to the taxable year is computed in the manner set forth in paragraph (d) of this section. Such net operating loss carryover or net operating loss carryback is considered a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(f) *Joint carryovers and carrybacks.*—The joint net operating loss carryovers and the joint net operating loss carrybacks to any taxable year for which a joint return is made are all the net operating loss carryovers and net operating loss carrybacks of both spouses to such taxable year. For example, a husband and wife file a joint return for the calendar year 1956, having a joint taxable income for such year. The wife filed a separate return for the calendar years 1954 and 1955, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1955, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1955. The husband sustained net operating losses in both such taxable years. Since the husband and wife did not file a joint return for any taxable year involved in the computation of the net operating loss carryovers to 1956 from 1954 and 1955, the joint net operating loss carryovers to 1956 are the separate net operating loss carryovers of the wife from the calendar years 1954 and 1955 and the separate net operating loss carryovers of the husband from the fiscal year ending June 30, 1955, and from the short taxable year ending December 31, 1955. If the husband and wife also file joint returns for the calendar years 1957 and 1958, having a joint taxable income in 1957 and a joint net operating loss in 1958, the joint net operating loss carrybacks to 1956 and 1957 from 1958 are computed on the basis of the joint net operating loss for 1958, since separate returns were not made for any taxable year involved in the computation of such carrybacks.

(g) *Illustration of principles.*—In the following examples, which illustrate the application of this section, it is assumed that reference to the modifications prescribed in § 1.172–5 is unnecessary and that the taxable income or loss in each case is the taxable income or loss determined without any net operating loss deduction. The taxpayers in each example, H, a husband, and W, his wife, report their income on the calendar-year basis.

Example (1). H and W filed joint returns for 1954 and 1955. They sustained a joint net operating loss of $1,000 for 1954 and a joint net operating loss of $2,000 for 1955. For 1954 the deductions of H exceeded his gross income by $700, and the deductions of W exceeded her gross income by $300, the total of such amounts being $1,000. Therefore, $700 of the $1,000 joint net operating loss for 1954 is considered the net operating loss of H for 1954, and $300 of such joint net operating loss is considered the net operating

loss of W for 1954. For 1955 the gross income of H exceeded his deductions, so that his separate taxable income would be $1,500, and the deductions of W exceeded her gross income by $3,500. Therefore, all of the $2,000 joint net operating loss for 1955 is considered the separate net operating loss of W for 1955.

Example (2). (i) H and W filed joint returns for 1954 and 1956, and separate returns for 1955 and 1957. For the years 1954, 1955, 1956, and 1957 they had taxable incomes and net operating losses as follows, losses being indicated in parentheses:

	1954	1955	1956	1957
H	($5, 000)	($2, 500)	$6, 500	($4, 000)
W	(3, 000)	2, 000	3, 000	(1, 500)
Total	($8, 000)	--------	$9, 500	--------

(ii) The net operating loss carryover of H from 1957 to 1958 is $4,000, that is, his $4,000 net operating loss for 1957 which is not reduced by any part of the taxable income for 1956, since none of such taxable income is attributable to H and the portion attributable to W is entirely offset by her separate net operating loss for her taxable year 1957, which taxable year begins on the same date as H's taxable year 1957. H's $4,000 net operating loss for 1957 likewise is not reduced by reference to 1955 since H sustained a loss in 1955. The $0 taxable income for 1956 which reduces H's net operating loss for 1957 is computed as follows:

(iii) The combined taxable income of $9,500 for 1956 is reduced to $1,000 by the net operating loss deduction for such year of $8.500. This net operating loss deduction is computed without taking into account any net operating loss of either H or W sustained in a taxable year beginning on or after January 1, 1957, the date of the beginning of the taxable year in which H sustained the net operating loss from which the taxable income is subtracted. This $8,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955, and of W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). None of the $1,000 combined taxable income for 1956 (computed with the net operating loss deduction described above) is attributable to H since it is caused by W's income (computed after deducting her separate carryover) offsetting H's loss (computed by deducting from his income his separate carryovers). No part of the $1,000 combined taxable income for 1956 which is attributable to W is used to reduce H's net operating loss for 1957 since such taxable income attributable to W must first be reduced by W's $1,500 net operating loss for 1957, her taxable year beginning on the same date as the taxable year of H in which he sustained the net operating loss from which the taxable income is subtracted.

(iv) The net operating loss carryover of W from 1957 to 1958 is $500, her $1,500 loss reduced by the sum of her $0 taxable income for 1955 (computed by taking into account her $3,000 carryover

from 1954) and her $1,000 taxable income for 1956, that is, the portion of the combined taxable income for 1956 which is attributable to her.

Example (3). (i) Assume the same facts as in example (2) except that for 1957 the net operating loss of W is $200 instead of $1,500.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,200, that is, his $4,000 net operating loss for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $800 taxable income for 1956. Such $800 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added $800, the excess of the $1,000 taxable income for such year attributable to W over her $200 net operating loss sustained in 1957, a taxable year beginning on the same date as the taxable year of H in which he sustained the $4,000 net operating loss from which the taxable income is subtracted.

(iv) W has no net operating loss carryover from 1957 to 1958 since her net operating loss of $200 for 1957 does not exceed the $1,000 taxable income for 1956 attributable to her.

Example (4). (i) Assume the same facts as in example (2), except that W changes her accounting period in 1957 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1957, to January 31, 1957, but has a net operating loss of $200 for the fiscal year February 1, 1957, to January 31, 1958.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,000, that is, his net operating loss of $4,000 for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $1,000 taxable income for 1956. Such $1,000 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in example (2), remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added the $1,000 taxable income attributable to W for such year. The taxable income attributable to W is not reduced by any amount since she does not have a net operating loss for her taxable year beginning on January 1, 1957, the date of the beginning of the taxable year of H in which he sustained the $4,000 net operating loss from which his taxable income is subtracted.

(iv) The net operating loss carryover of W from the fiscal year beginning February 1, 1957, to her next fiscal year is $200, that is, her net operating loss of $200 for the fiscal year beginning February 1, 1957, reduced by the sum of her $0 taxable income for 1956 and her $0 taxable income for the taxable year January 1, 1957, to January 31, 1957 (a year in which she had no income). The $0 taxable income for 1956 is computed as follows:

(v) The combined taxable income of $9,500 for 1956 is reduced

to $0 amount by the net operating loss deduction for such year of $12,500. This net operating loss deduction is computed by taking into account the net operating loss of H for 1957 since it was sustained in a taxable year beginning before February 1, 1957, the date of the beginning of the taxable year of W in which she sustained the $200 net operating loss from which her taxable income is subtracted. This $12,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955 and of his carryback of $4,000 from 1957, plus W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). Since there is no combined taxable income for 1956, there is no taxable income attributable to W for such year.

§ 1.172–8 Net Operating Loss Carryback for Purposes of the Excess Profits Tax.—(a) *Applicable rule.*—In computing the excess profits tax imposed by subchapter D of chapter 1 of the 1939 Code, excess profits net income shall be computed as if section 172 of the 1954 Code had not been enacted and as if section 122 of the 1939 Code were applicable to all pertinent taxable years to which the 1954 Code is otherwise applicable.

(b) *Illustrations.*—The application of paragraph (a) of this section may be illustrated as follows:

(1) *Net operating loss.*—The net operating loss itself, even though it is sustained in a taxable year which is otherwise subject to the 1954 Code, shall be computed for this purpose under the provisions of section 122 of the 1939 Code and § 39.122–2 of Regulations 118 (26 CFR (1939) 39.122–2) or the corresponding section of prior applicable regulations.

(2) *Net operating loss carryback.*—(i) Since section 122 of the 1939 Code allows only a one-year carryback of a loss sustained in a taxable year beginning after December 31, 1949, only such one-year carryback shall be allowed for purposes of computing excess profits net income even though the loss is sustained in a taxable year ending after December 31, 1953, for which section 172(b)(1) otherwise allows a two-year carryback.

(ii) Thus, a calendar year taxpayer which sustains a net operating loss in 1954 may carry such loss back to both 1952 and 1953 for purposes of computing the normal tax and surtax imposed by sections 13 and 15, respectively, of the 1939 Code, but may carry such loss back only to 1953 for purposes of computing excess profits net income in determining the excess profits tax imposed by subchapter D of chapter 1 of the 1939 Code. Such 1954 loss shall have no effect on the determination of the excess profits tax for 1952. The amount of the carryback from 1954 to 1953 for purposes of determining the excess profits tax for 1953 is an amount equal to the amount of the net operating loss computed as provided in subparagraph (1) of this paragraph.

(iii) A net operating loss sustained in the calendar year 1955 by such taxpayer may be carried back to 1953 for purposes of computing normal tax and surtax but shall have no effect on the determination of the excess profits tax for 1953 or for any other year.

§ 1.214 Statutory Provisions; Additional Itemized Deductions for Individuals; Expenses for Care of Certain Dependents.

SEC. 214. EXPENSES FOR CARE OF CERTAIN DEPENDENTS.

(a) General Rule.—There shall be allowed as a deduction expenses paid during the taxable year by a taxpayer who is a woman or a widower for the care of one or more dependents (as defined in subsection (c)(1)), but only if such care is for the purpose of enabling the taxpayer to be gainfully employed.

(b) Limitations.—

(1) In general.—The deduction under subsection (a)—

(A) shall not exceed $600 for any taxable year; and

(B) shall not apply to any amount paid to an individual with respect to whom the taxpayer is allowed for his taxable year a deduction under section 151 (relating to deductions for personal exceptions).

(2) Working wives.—In the case of a woman who is married, the deduction under subsection (a)—

(A) shall not be allowed unless she files a joint return with her husband for the taxable year, and

(B) shall be reduced by the amount (if any) by which the adjusted gross income of the taxpayer and her spouse exceeds $4,500.

This paragraph shall not apply if the taxpayer's husband is incapable of self-support because mentally or physically defective.

(c) Definitions.—For purposes of this section—

(1) Dependent.—The term "dependent" means a person with respect to whom the taxpayer is entitled to an exemption under section 151(e)(1)—

(A) who has not attained the age of 12 years and who (within the meaning of section 152) is a son, stepson, daughter, or stepdaughter of the taxpayer; or

(B) who is physically or mentally incapable of caring for himself.

(2) Widower.—The term "widower" includes an unmarried individual who is legally separated from his spouse under a decree of divorce or of separate maintenance.

(3) Determination of status.—A woman shall not be considered as married if she is legally separated from her spouse under a decree of divorce or of separate maintenance at the close of the taxable year.

§ 1.214–1 Expenses for the Care of Certain Dependents.—(a) *General rule.*—Section 214 allows a deduction from gross income of expenses paid for the care of certain dependents where the care is for the purpose of enabling the taxpayer to be gainfully employed. Such expenses are referred to in this section as "child care" expenses. The deduction may not exceed $600 for any taxable year (regardless of the number of dependents for whose care the expenses are paid) and is allowed only for expenses incurred while the taxpayer is gainfully employed or in active search of gainful employment. The employment which is the cause of the incurring of the expenses may, however, consist of services either within or without the home of the taxpayer. Self-employment constitutes employment for purposes of section 214.

(b) *Taxpayers who may qualify for the deduction.*—The deduction provided in section 214 is allowed only to a woman or a widower. For the purpose of this paragraph, the following rules apply:

(1) *A widower.*—The deduction is allowed for expenses paid by a taxpayer who is a widower at the time the expenses are incurred. The term "widower" includes (i) a man whose wife has died and

who has not remarried, (ii) a man who is divorced from his wife, and has not remarried, and (iii) a man who is legally separated from his wife under a decree of legal separation.

(2) *A married woman whose husband is capable of self-support.*—If the expenses are paid by a woman (i) who is married at the time the expenses are incurred, (ii) whose husband at that time is not incapable of self-support because he is mentally defective or physically disabled, and (iii) who is not divorced or legally separated at the end of the taxable year, the deduction is allowed, but only if she files a joint income tax return with her husband for the taxable year in which the expenses are paid. Further, the amount otherwise deductible shall be reduced by the amount, if any, by which the combined adjusted gross income of the taxpayer and her spouse exceeds $4,500 for the taxable year in which the expenses are paid. The amount otherwise deductible is the amount expended for child care or $600, whichever is lesser. The determination of whether the taxpayer's husband is incapable of self-support because of a mental defect or physical disability shall be made without regard to his income from sources other than his own earnings. For purposes of this subparagraph, the term "earnings" means wages, salaries, commissions, professional fees, and other amounts received as compensation for personal services actually rendered. It does not include income such as pensions, annuities, sick-pay, interest, dividends, or rents.

(3) *A married woman whose husband is incapable of self-support.*—(i) The deduction is allowed without regard to the limitations described in subparagraph (2) of this paragraph for expenses paid by a married woman whose husband is incapable of self-support because he is mentally defective or physically disabled (as defined in subparagraph (2) of this paragraph) at the time the expenses are incurred.

(ii) A married woman claiming a deduction under this subparagraph shall attach to her income tax return in which the deduction is claimed a statement disclosing (*a*) the nature of her husband's disability, (*b*) the period of the disability, and (*c*) if her husband had earnings during the period, the amount of such earnings. Where the husband is capable of self-support for part of a taxable year the child care expenses incurred for such part shall be treated under subparagraph (2) of this paragraph. See example (8) of paragraph (c) of this section.

(4) *A single woman.*—The deduction is also allowed without regard to the limitation described in subparagraph (2) of this paragraph for expenses paid by a woman who (i) is unmarried at the time the expenses are incurred, or (ii) is, at the close of her taxable year, legally separated from her husband under a decree of divorce or of separate maintenance.

(5) *Determination of status.*—If child care expenses are incurred in one taxable year and paid in another, the status of a taxpayer described in subparagraphs (1) to (4) of this paragraph, inclusive, shall be determined as of the year in which the expenses are incurred, and not when such expenses are paid.

(c) *Computation of deduction.*—The deduction for child care ex-

penses is allowable only with respect to such expenses actually paid during the taxable year regardless of when the event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. If child care expenses are incurred but not paid during the taxable year, no deduction can be taken for such year. Thus, if an expenditure was incurred in December 1955, but not paid until January 1956, no deduction may be taken for the calendar year 1955. The following examples illustrate the computation of the deduction allowed by section 214 in the case of a taxpayer making his return on the basis of the calendar year. In each example it is assumed that the expenses are of the type which would qualify for the deduction.

Example (1). M was a widower during 1954, until September 1, when he remarried. He paid $50 each month in 1954 for child care expenses. He may take into account, for purposes of the deduction allowed by section 214, only the expenses paid during the taxable year which were incurred while he was unmarried. Since the expenses were $400 ($50 per month from January to August, inclusive), the amount of the deduction is $400. If M had paid $100 per month during 1954, the deduction would be limited to $600, although the expenses incurred while M was unmarried amount to $800.

Example (2). H and W were married during the entire year 1954. W, the wife, paid $900 for child care expenses incurred during the year. The combined adjusted gross income of H and W for 1954 was $5,000. The allowable deduction under section 214 is $100 ($600, the maximum deduction allowable, reduced by $500, the excess of adjusted gross income of $5,000 over $4,500). The deduction of $100 is allowable only if H and W made a joint return for 1954.

Example (3). The facts are the same as in example (2), except that the child care expenses paid during the year were $400. No deduction is allowable under section 214, since the amount of expenses paid, $400, is less than $500 (the excess of the adjusted gross income over $4,500).

Example (4). During 1954, W, a woman, paid $50 each month for child care expenses. She was unmarried until April 1, 1954, and was married for the remainder of the year. H, her husband, was capable of self-support, and the combined adjusted gross income of husband and wife was $4,700. H and W made a joint return for 1954. The total deduction allowable to W under section 214 is $400, computed as follows: $150 as expenses incurred while W was a single woman, and $250 as expenses incurred while W was married; the $250 is arrived at by taking the amount expended while H and W were married, $450, and reducing it by $200 (the excess of adjusted gross income, $4,700 over $4,500).

Example (5). The facts are the same as in example (4), except that the amounts paid are $75 per month ($225 being paid for expenses incurred while W was single and $675 while she was married). The total allowable deduction in this case is $600. $225 is deductible as expenses incurred while W was a single woman. $400

of the expenses incurred during the period of marriage is also deductible. However, the maximum deduction allowable to W is $600. The allowable amount for expenses incurred during the period of marriage is determined as follows: $675 (the amount expended during the period) is reduced to $600 (the maximum deduction allowable) and $600 is then reduced by $200 (the excess of adjusted gross income $4,700 over $4,500) to $400.

Example (6). H and W were married during 1954 prior to July 1, when they received a decree of divorce. She did not remarry during 1954. W paid $100 per month for child care expenses during 1954. The allowable deduction is $600. Since W is considered to have been a single woman during all of 1954, the limitations with respect to the deduction allowed to a married woman are not applicable, and only the $600 limitation applies.

Example (7). H and W married on July 1, 1954. At all times in 1954, until July 1, H was a widower and W was a widow. H and W each paid $750 for child care in 1954, prior to their marriage. Each is allowed a deduction for 1954 of $600, regardless of their adjusted gross income and of the amount of their child care expenditures while married, and whether or not a joint return was filed. However, no additional deduction would be allowed for child care expenses paid after their marriage.

Example (8). H and W were married at all times during the year 1954. As a result of an accident, H incurred injuries which rendered him incapable of self-support during 1954 until September 1. The adjusted gross income of H and W for 1954 was $4,700. W paid $60 each month in 1954 for child care expenses. The deduction allowable to W by section 214 is $520. This amount is composed of $480, representing the amounts paid during H's period of disability, and $40, representing the allowable deduction of expenses paid in the amount of $240 from September to December, inclusive ($240 is reduced by $200, the excess of the adjusted gross income ($4,700) over $4,500).

Example (9). H and W were married from January 1, 1954 to October 1, 1954, when H died. The combined adjusted gross income of the spouses was $4,800. W paid $50 per month for child care expenses throughout the entire year. The deduction allowed to W if she filed a separate return is $150, the amount paid while she was a widow. If a joint return is filed on behalf of the widow and her deceased husband, the deduction allowable is $300 which includes $150 deductible as a married woman (the amount expended during marriage, $450, being reduced by $300, the excess of $4,800 over $4,500).

(d) *Dependents.*—(1) The deduction provided by section 214 is allowed only for expenses paid for the care of an individual who (for the taxable year of the taxpayer in which the expenses are incurred) is a dependent of the taxpayer for whom an exemption is allowed under section 151(e)(1). Furthermore, the dependent must, at the time the expenses are incurred, be either—

(i) Under the age of 12 years, or

(ii) Physically or mentally unable to care for himself. It is not

necessary that the dependent be permanently disabled in order for the amount expended for his care to be deductible. However, the mere fact that the disability, whether temporary or permanent, renders him incapable of self-support does not necessarily mean that he is incapable of self-care within the meaning of this subdivision. The deduction for expenses paid for the care of a dependent under the age of 12 years is allowed even though the dependent is not a child or stepchild of the taxpayer.

(2) The rules provided in sections 151 and 152, with respect to the definition and qualification of an individual as a dependent, govern for the purpose of section 214. Thus, expenses for the care of a child or stepchild of the taxpayer under 12 whom the taxpayer supports are deductible even though the child or stepchild has gross income of $600 or more. On the other hand, expenses for the care of an aged parent would not be deductible if the gross income condition of section 151(e)(1)(A) is not met. The term "dependent" does not include the spouse of a taxpayer.

(e) *Payments to a dependent.*—No deduction is allowed under section 214 for expenses paid to an individual for whom the taxpayer is allowed, for the taxable year in which the expenses are paid, an exemption under section 151. Thus, if the taxpayer, a working widow, supports her mother and is entitled to claim her as a dependent, she may not deduct amounts paid to the mother for the care of the taxpayer's children.

(f) *What expenses are deductible.*—(1) *In general.*—In order for an expense to be deductible under section 214, it must meet three conditions: First, the expense must be for the care of a dependent; second, it must be for a dependent's care while the taxpayer is gainfully employed or in search of gainful employment; and third, the expense must be for the purpose of enabling the taxpayer to be gainfully employed. In determining whether an expense meets these conditions, all the facts and circumstances of the case must be taken into consideration.

(2) *Definition of care of a dependent.*—(i) In general, the phrase "expenses for the care of a dependent" means amounts expended for the primary purpose of assuring the dependent's well being and protection. It does not include all benefits which may be bestowed upon him. Accordingly, amounts expended to provide food, clothing, or education, are not, in themselves, amounts expended for "care" so as to be deductible under section 214. However, where the manner of providing care is such that the expense which must be incurred includes payments for other benefits which are inseparably a part of the care, the full amount of the expense will be considered to be incurred for care. Thus, the full amount paid to a nursery school will be considered to be for the care of the child, even though the school also furnishes lunch, recreational activities, and other benefits.

(ii) The manner of providing the care need not be the least expensive method available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to afford the taxpayer's child adequate care. Regardless of this fact, the expense incurred for the child at a nursery school or day camp may be expense

for the care of the child. See, however, subparagraph (4) of this paragraph with respect to the requirement that the expense must be for the purpose of enabling the taxpayer to be gainfully employed.

(iii) Where a portion of an expenditure is for the care of a dependent and a portion is for other unrelated purposes, a reasonable allocation shall be made and only the portion of the amount paid which is attributable to the care shall be considered an amount to which section 214 is applicable. This rule is applicable if, for example, a servant performs household duties and also cares for the children of the taxpayer. In this case, however, where one of the children is under 12, and the other (or others) is over 12, there need be no further allocation between the children under 12 years and those over that age.

(3) *Period of employment.*—Since the deduction is allowed only for expenses for care for those periods during which the taxpayer is gainfully employed (or in active search of gainful employment), an allocation may be required when an expense covers periods of care in which no employment is involved. Thus, if a taxpayer pays $50 each month during the year for care of his child at a foster home, and the taxpayer is employed (or in search of employment) for only two months during the year, the deduction is limited to $100.

(4) *Purpose of expenditure.*—Even if an expense is incurred for the care of a dependent, it is not deductible unless it is incurred for the purpose of permitting the taxpayer to be gainfully employed. Whether that is the true purpose of the expense depends upon the facts and circumstances of the particular case. Thus, the fact that the cost of providing care for a dependent is greater than the amounts anticipated to be received from the employment of the taxpayer may indicate that the purpose of the expenditure is other than to permit the taxpayer to be gainfully employed.

(5) *Examples.*—The following examples illustrate the application of this paragraph:

Example (1). A widow has a child who is too young to attend public school. In order that she may be gainfully employed, the widow places the child in a nursery school while she is at work. The expenses paid to the nursery school are child care expenses to which the deduction under section 214 is applicable. Assuming the nursery school provides lunch for the child, no allocation is required between that part of the expense which might be considered to be for the lunch as distinguished from the expense of assuring the child's protection.

Example (2). The taxpayer, a single woman, in order to be gainfully employed employs a housekeeper who cares for the taxpayer's two children, aged 9 and 13 years, respectively, in addition to performing regular household duties of cleaning and cooking. If it is assumed that the compensation paid to the housekeeper is $1,200 during the year, and that $500 is allocated to the care of the children, a deduction of $500 is allowed under section 214. No allocation is required for purposes of determining which part of the $500 is for the care of the 9-year-old child. If the expenses allocable to the care of the children were $700, the amount of the deduction

would be $600, the maximum amount allowable in a taxable year under section 214.

Example (3). The taxpayer, a single woman, has a dependent grandchild 10 years of age who has been attending public school. The taxpayer who has been working part time is offered a position involving full-time employment which she can accept only if arrangements are made for the care of the child from 8 a. m. to 5:30 p. m. Such arrangements are made at a private school to which she sends the child. The expenses paid to the school are for the care of the child without allocation between that part of the expense which represents tuition and that part which represents true care. The expense is considered to be incurred for the purpose of enabling the taxpayer to be gainfully employed.

Example (4). The taxpayer, a widow with a substantial income, has a child aged 11 who has been attending boarding school for several years. The taxpayer, who has been performing gratuitous services for a philanthropic organization, accepts a part-time job with the organization for which she is paid a small salary. From these facts it would appear that the expense of continuing the child in the boarding school is not for the purpose of enabling the taxpayer to be gainfully employed, whether or not the expense is considered to be incurred for the care of the child.

Example (5). The taxpayer, a widower, has a child who is physically incapable of caring for himself. In order to be gainfully employed the taxpayer sends the child to a school for children who are physically handicapped. The expense of the school, whether a day school or a boarding school, is a child care expense.

Example (6). The taxpayer, a single woman, lives with her mother who is an invalid incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother while the taxpayer is at work. The expense paid to the nurse may be a "child care" expense.

(g) *Expenses qualifying under section 213.*—(1) An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also, as an example (6) of paragraph (f) of this section, constitute an expense for which a deduction is allowable under section 214. In such a case, that part of the amount for which a deduction is allowed under section 214 shall not be treated as an expense under section 213.

(2) On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it shall not be allowed as a deduction under section 214.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). W, a single woman, pays $720 during the taxable year for the care of her child who suffers from infantile paralysis. It is assumed that the expenses are of a nature which qualify as medical expenses under section 213. It is also assumed that these

expenses are for the purpose of permitting W to be gainfully employed. W's adjusted gross income for the taxable year is $5,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance of the expenses, or $120, she treats as medical expenses. However, this amount does not exceed 3 percent of her adjusted gross income and is thus not allowable as a deduction under section 213.

Example (2). It would not be proper in the case presented in (1) for W first to determine under section 213 her deductible medical expenses (which would be $570 ($720 less 3%×$5,000)), and then claim as a deduction under section 214 the $150 which is not deductible under section 213. The $150 would be disallowed under section 214 for the reason that it was treated as a medical expense in determining the amount deductible under section 213.

Example (3). W, a single woman under the age of 65 years, is also the head of a household. She pays $12,000 during the taxable year for child care expense which also qualify as medical expenses under section 213. W's adjusted gross income for the taxable year is $18,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance, or $11,400, is treated as medical expenses. The allowable deduction under section 213 for such expenses is the excess of 3 percent of W's adjusted gross income, or $10,860, but subject to the maximum limitation in section 213.

SPECIAL DEDUCTIONS FOR CORPORATIONS

§ 1.241 Statutory Provisions; Allowance of Special Deductions.

SEC. 241. ALLOWANCE OF SPECIAL DEDUCTIONS.

In addition to the deductions provided in part VI (sec. 161 and following), there shall be allowed as deductions in computing taxable income the items specified in this part.

§ 1.241–1 Allowance of Special Deductions.—A corporation, in computing its taxable income, is allowed as deductions the items specified in part VIII of subchapter B of chapter 1 (sections 242 through 248) in addition to the deductions provided in part VI (section 161 and following).

§ 1.242 Statutory Provisions; Partially Tax-Exempt Interest.

SEC. 242. PARTIALLY TAX-EXEMPT INTEREST.

(a) Allowance of Deduction.—There shall be allowed to a corporation as a deduction the amount received as interest on obligations of the United States or on obligations of corporations organized under Act of Congress which are instrumentalities of the United States, but only if—

(1) such interest is included in gross income; and

(2) such interest is exempt from normal tax under the Act authorizing the issuance of such obligations.

(b) Cross Reference.—For reduction of deduction under subsection (a) on account of amortizable bond premium, see section 171.

§ 1.242–1 Deduction for Partially Tax Exempt Interest.—A corporation is allowed a deduction under section 242(a) in an amount equal to certain interest received on obligations of the United States, or on obligations of corporations organized under acts of Congress

which are instrumentalities of the United States. The interest for which a deduction shall be allowed is interest which is included in gross income and which is exempt from normal tax under the Act as amended and supplemented which authorized the issuance of the obligations.

§ 1.243 STATUTORY PROVISIONS; DIVIDENDS RECEIVED BY CORPORATIONS.

SEC. 243. DIVIDENDS RECEIVED BY CORPORATIONS.

(a) GENERAL RULE.—In the case of a corporation, there shall be allowed as a deduction an amount equal to 85 percent of the amount received as dividends (other than dividends described in paragraph (1) of section 244, relating to dividends on the preferred stock of a public utility) from a domestic corporation which is subject to taxation under this chapter.

(b) SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—For purposes of subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

(2) A dividend received from a regulated investment company shall be subject to the limitations prescribed in section 854.

§ 1.243-1 DEDUCTION FOR DIVIDENDS RECEIVED BY CORPORATIONS.—(a) A corporation is allowed a deduction under section 243(a) for dividends received from a domestic corporation which is subject to taxation under chapter 1 of the Internal Revenue Code. The deduction for a taxable year, except as provided in subsection (b) of section 243 and in section 246, is an amount equal to 85 percent of such dividends received by the corporation during the taxable year. To determine the amount of the distribution to a recipient corporation and the amount of the dividend, see § 1.301-1 and § 1.316-1.

(b) The deduction allowed by section 243 shall be determined without regard to any dividends described in paragraph (1) of section 244 (relating to dividends on the preferred stock of a public utility). That is, such deduction shall be determined without regard to any dividends received on the preferred stock of a public utility which is subject to taxation under chapter 1 of the Internal Revenue Code and with respect to which a deduction is allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities). For a deduction with respect to such dividends received on the preferred stock of a public utility, see section 244. If a deduction for dividends paid is not allowable to the distributing corporation under section 247 with respect to the dividends on its preferred stock, such dividends received from a domestic public utility corporation subject to taxation under chapter 1 of the Internal Revenue Code are includible in determining the deduction allowed by section 243(a).

(c) For limitation of dividends received deduction, see section 246 and the regulations thereunder.

§ 1.243-2 SPECIAL RULES FOR CERTAIN DISTRIBUTIONS.—(a) *Dividends paid by mutual savings banks, etc.*—In determining the deduction provided in section 243(a), any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, cooperative banks, and domestic building and loan associations) shall not be considered as a dividend.

(b) *Dividends received from regulated investment companies.*—

In determining the deduction provided in section 243(a), dividends received from a regulated investment company shall be subject to the limitations provided in section 854.

§ 1.244 STATUTORY PROVISIONS; DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.

SEC. 244. DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.

In the case of a corporation, there shall be allowed as a deduction an amount computed as follows:

(1) First determine the amount received as dividends on the preferred stock of a public utility which is subject to taxation under this chapter and with respect to which the deduction provided in section 247 for dividends paid is allowable.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

(3) Finally ascertain the amount which is 85 percent of the excess of—

(A) the amount determined under paragraph (1), over

(B) the amount determined under paragraph (2).

§ 1.244-1 DEDUCTION FOR DIVIDENDS RECEIVED ON CERTAIN PREFERRED STOCK.—A corporation is allowed a deduction under section 244 for dividends received on certain preferred stock of certain public utility corporations subject to taxation under chapter 1 of the Internal Revenue Code. The deduction is allowable only for dividends received on the preferred stock of a public utility with respect to which the deduction for dividends paid provided in section 247 (relating to dividends paid on certain preferred stock of public utilities) is allowable to the distributing corporation.

§ 1.244-2 COMPUTATION OF DEDUCTION.—(a) Section 244 provides a specific rule for the computation of the deduction for dividends received on the preferred stock of a public utility. The deduction computed under section 244 is subject to the limitation provided in section 246.

(b) The computation of the deduction provided in section 244 may be illustrated by the following examples:

Example (1). Corporation A, which files its income tax returns on the calendar year basis, received in 1954 $100,000 as dividends on the preferred stock of Corporation B, a public utility corporation which is subject to taxation under chapter 1 of the Internal Revenue Code. The deduction provided in section 247 is allowable to Corporation B, the distributing corporation, with respect to these dividends. The corporation normal tax rate and the surtax rate for the calendar year 1954 are 30 percent and 22 percent, respectively. The deduction allowable to Corporation A under section 244 for the year 1954 with respect to these dividends is $62,115.38, computed as follows:

Dividends received on preferred stock of Corporation B	$100,000.00
Less: The fraction specified in section (244)(2) $\frac{14}{52}\times\$100{,}000$	26,923.08
Amount subject to 85 percent deduction	$73,076.92
Deduction: 85 percent of $73,076.92	$62,115.38

Example (*2*). Assume the facts are the same as in example (1) except that the year involved is a taxable year for which the corporation normal tax rate and the surtax rate are 25 percent and 22 percent, respectively. The deduction allowable to Corporation A under section 244 for that taxable year is $59,680.85, computed as follows:

Dividends received on preferred stock of Corporation B	$100,000.00
Less: The fraction specified in section 244(2) $\frac{14}{47}\times$\$100,000	29,787.23
Amount subject to 85 percent deduction	$70,212.77
Deduction: 85 percent of $70,212.77	$59,680.85

§ 1.245 Statutory Provisions; Dividends Received From Certain Foreign Corporations.

SEC. 245. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS

In the case of dividends received from a foreign corporation (other than a foreign personal holding company) which is subject to taxation under this chapter, if, for an uninterrupted period of not less than 36 months ending with the close of such foreign corporation's taxable year in which such dividends are paid (or, if the corporation has not been in existence for 36 months at the close of such taxable year, for the period the foreign corporation has been in existence as of the close of such taxable year) such foreign corporation has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States, there shall be allowed as a deduction in the case of a corporation—

(1) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of its earnings and profits specified in paragraph (2) of the first sentence of section 316(a), but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such earnings and profits as the gross income of such foreign corporation for the taxable year from sources within the United States bears to its gross income from all sources for such taxable year, and

(2) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of that part of its earnings and profits specified in paragraph (1) of the first sentence of section 316(a) accumulated after the beginning of such uninterrupted period, but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such accumulated earnings and profits as the gross income of such foreign corporation from sources within the United States for the portion of such interrupted period ending at the beginning of such taxable year bears to its gross income from all sources for such portion of such uninterrupted period.

§ 1.245–1 Deduction for Dividends Received From Certain Foreign Corporations.—(a) A corporation is allowed a deduction under section 245 for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under chapter 1 of the Internal Revenue Code if, for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid, such foreign corporation has been engaged in trade or business within the United States and has derived 50 percent or more of its gross income from sources within the United States. If the foreign corporation has been in existence less than 36 months as of the close of the taxable year in which the dividends are

paid, then the applicable uninterrupted period to be taken into consideration in lieu of the uninterrupted period of 36 or more months is the entire period such corporation has been in existence as of the close of such taxable year. An uninterrupted period which satisfies the twofold requirement with respect to business activity and gross income may start at a date later than the date on which the foreign corporation first commenced an uninterrupted period of engaging in trade or business within the United States, but the applicable uninterrupted period is in any event the longest uninterrupted period which satisfies such twofold requirement.

(b) The deduction provided in section 245 for a taxable year, except as provided in section 246, is the sum of the amounts computed under paragraphs (1) and (2) of section 245.

(c) The determination of earnings and profits distributed in any taxable year shall be made in accordance with the principles of section 316(a). For the determination of the source of income, see part I of subchapter N of chapter 1 (sections 861 through 864) and the regulations thereunder.

(d) The application of section 245 may be illustrated by the following examples:

Example (1). Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by Corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1943, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1954. Corporation A had accumulated earnings and profits of $50,000 immediately prior to January 1, 1943, and had earnings and profits of $10,000 for each taxable year during the uninterrupted period from January 1, 1943, through December 31, 1954. It derived for the period from January 1, 1943, through December 31, 1953, 90 percent of its gross income from sources within the United States and in 1954 derived 95 percent of its gross income from sources within the United States. During the calendar years 1943, 1944, 1945, 1946, and 1947 Corporation A distributed in each year $15,000; during the calendar years 1948, 1949, 1950, 1951, 1952, and 1953 it distributed in each year $5,000; and during the year 1954, $50,000. An analysis of the accumulated earnings and profits under the above statement of facts discloses that at December 31, 1953, the accumulation amounted to $55,000, of which $25,000 was accumulated prior to the "uninterrupted period" and $30,000 was accumulated during the uninterrupted period. (See section 316(a) and paragraph (c) of this section.) For 1954 a deduction under section 245 of $31,025 ($8,075 on 1954 earnings of the foreign corporation, plus $22,950 from the $30,000 accumulation at December 31, 1953) for dividends received from a foreign corporation is allowable to Corporation B with respect to the $50,000 received from Corporation A, computed as follows:

(i) $8,075, which is $8,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of the $10,000 of earnings and profits of the taxable year) multiplied by 95 percent (the portion of the gross income of Corporation

A derived during the taxable year 1954 from sources within the United States), plus

(ii) $22,950, which is $25,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of $30,000, the part of the earnings and profits accumulated after the beginning of the uninterrupted period) multiplied by 90 percent (the portion of the gross income of Corporation A derived from sources within the United States during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example (2). If in example (1), Corporation A for the taxable year 1954 had incurred a deficit of $10,000 (shown to have been incurred before December 31) the amount of the earnings and profits accumulated after the beginning of the uninterrupted period would be $20,000. If Corporation A had distributed $50,000 on December 31, 1954, the deduction under section 245 for dividends received from a foreign corporation allowable to Corporation B for 1954 would be $15,300, computed by multiplying $17,000 (85 percent—the percent specified in section 243 for the calendar year 1954—of $20,000 earnings and profits accumulated after the beginning of the uninterrupted period) by 90 percent (the portion of the gross income of Corporation A derived from United States sources during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

§ 1.246 Statutory Provisions; Rules Applying to Deductions for Dividends Received.

SEC. 246. RULES APPLYING TO DEDUCTIONS FOR DIVIDENDS RECEIVED.

(a) Deduction Not Allowed for Dividends From Certain Corporations.—The deductions allowed by sections 243, 244, and 245 shall not apply to any dividend from—

(1) a corporation organized under the China Trade Act, 1922 (see sec. 941); or

(2) a corporation which, for the taxable year of the corporation in which the distribution is made, or for the next preceding taxable year of the corporation, is—

(A) a corporation exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations); or

(B) a corporation to which section 931 (relating to income from sources within possessions of the United States) applies.

(b) Limitation on Aggregate Amount of Deductions.—

(1) General rule.—Except as provided in paragraph (2), the aggregate amount of the deductions allowed by sections 243, 244, and 245 shall not exceed 85 percent of the taxable income computed without regard to the deductions allowed by sections 172, 243, 244, 245, and 247.

(2) Effect of net operating loss.—Paragraph (1) shall not apply for any taxable year for which there is a net operating loss (as determined under section 172).

§ 1.246-1 Deductions Not Allowed for Dividends From Certain Corporations.—The deductions provided in sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), are not allowable with respect to any dividend received from—

(a) A corporation organized under the China Trade Act, 1922 (15 U. S. C. ch. 4) (see section 941); or

(b) A corporation which is exempt from tax under section 501

(relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations) for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; or

(c) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year.

§ 1.246–2 LIMITATION ON AGGREGATE AMOUNT OF DEDUCTIONS.—(a) *General rule.*—The sum of the deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), except as provided in section 246(b)(2) and in paragraph (b) of this section, is limited to 85 percent of the taxable income of the corporation. The taxable income of the corporation for this purpose is computed without regard to the net operating loss deduction allowed by section 172, the deduction for dividends paid on certain preferred stock of public utilities allowed by section 247, and the deductions provided in sections 243, 244, and 245. For definition of the term "taxable income," see section 63.

(b) *Effect of net operating loss.*—If the shareholder corporation has a net operating loss (as determined under section 172) for a taxable year, the limitation provided in section 246(b)(1) and in paragraph (a) of this section is not applicable for such taxable year. In that event, the deductions provided in sections 243, 244, and 245 shall be allowable for all tax purposes to the shareholder corporation for such taxable year without regard to such limitation. If the shareholder corporation does not have a net operating loss for the taxable year, however, the limitation will be applicable for all tax purposes for such taxable year. In determining whether the shareholder corporation has a net operating loss for a taxable year under section 172, the deductions allowed by sections 243, 244, and 245 are to be computed without regard to the limitation provided in section 246(b)(1) and in paragraph (a) of this section.

§ 1.247 STATUTORY PROVISIONS; DIVIDENDS PAID ON CERTAIN PREFERRED STOCK OF PUBLIC UTILITIES.

SEC. 247. DIVIDENDS PAID ON CERTAIN PREFERRED STOCK OF PUBLIC UTILITIES.

(a) AMOUNT OF DEDUCTION.—In the case of a public utility, there shall be allowed as a deduction an amount computed as follows:

(1) First determine the amount which is the lesser of—

(A) the amount of dividends paid during the taxable year on its preferred stock, or

(B) the taxable income for the taxable year (computed without the deduction allowed by this section).

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent, and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year specified in section 11.

For purposes of the deduction provided in this section, the amount of dividends paid shall not include any amount distributed in the current tax-

able year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. Amounts distributed in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year shall for purposes of this subsection be deemed to be distributed with respect to the earliest year or years for which there are dividends unpaid and accumulated.

(b) DEFINITIONS.—For purposes of this section and section 244—

(1) PUBLIC UTILITY.—The term "public utility" means a corporation engaged in the furnishing of telephone service or in the sale of electrical energy, gas, or water, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof.

(2) PREFERRED STOCK.—The term "preferred stock" means stock issued before October 1, 1942, which during the whole of the taxable year (or the part of the taxable year after its issue) was stock the dividends in respect of which were cumulative, limited to the same amount, and payable in preference to the payment of dividends on other stock. Stock issued on or after October 1, 1942, shall be deemed for purposes of this paragraph to have been issued before October 1, 1942, if it was issued (including issuance either by the same or another corporation in a transaction which is a reorganization (as defined in section 368(a)), a transaction to which section 371 (relating to insolvency reorganizations) applies, or a transaction subject to part VI of subchapter O (relating to exchanges in SEC obedience orders), or the respectively corresponding provisions of the Internal Revenue Code of 1939) to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock (including stock which is preferred stock by reason of this sentence), but only to the extent that the par or stated value of the new stock does not exceed the par, stated, or face value of the bonds or debentures issued before October 1, 1942, or the other preferred stock, which such new stock is issued to refund or replace. The determination of whether stock was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, shall be made under regulations prescribed by the Secretary or his delegate.

§ 1.247–1 DEDUCTION FOR DIVIDENDS PAID ON PREFERRED STOCK OF PUBLIC UTILITIES.—(a) *Amount of deduction.*—(1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section). This deduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is 14/52. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will be

14/47. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays $100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than $100,000 the deduction allowable to Corporation A under section 247 for 1954 is $100,000 times 14/52, or $26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been $90,000 (that is, less than the amount of the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been $90,000 times 14/52, or $24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247(a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility states that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under section 247 to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(3) If a corporation which is engaged in one or more of the four types of business activities (called utility activities in this section) enumerated in section 247(b)(1) (the furnishing of telephone service or the sale of electrical energy, gas, or water) is also engaged in some other business that does not fall within any of the enumerated categories, the deduction under section 247 is allowable only for such portion of the amount computed under section 247(a) as is allocable to the income from utility activities. For this purpose, the allocation may be made on the basis of the ratio which the total income from the utility activities bears to total income from all sources (total income

being considered either gross income or gross receipts, whichever method results in the higher deduction). However, if such an allocation reaches an inequitable result and the books of the corporation are so kept that the taxable income attributable to the utility activities can be readily determined, particularly where the books of the corporation are required by governmental bodies to be so kept for rate making or other purposes, the allocation may be made upon the basis of taxable income. No such apportionment will be required if the income from sources other than utility activities is less than 20 percent of the total income of the corporation, irrespective of the method used in determining such total income.

(b) *Public utility.*—As used in section 247 and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The deduction provided in section 247 will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States, or from the operation of more than one such system and (2) that the regulation to which it is subject in part of its operating territory in one such system is effective to control rates within the unregulated territory of the same system so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock.*—(1) For the purposes of section 247 and this section, preferred stock means stock (i) which was issued before October 1, 1942, (ii) the dividends in respect of which (during the whole of the taxable year, or the part of the taxable year after the actual date of the issue of such stock) were cumulative, nonparticipating as to current distributions, and payable in preference to the payment of dividends on other stock, and (iii) the rate of return on which is fixed and cannot be changed by a vote of the board of

directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the deduction provided in section 247 shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of section 247 and this section whether the stock be voting or nonvoting stock.

(2) Preferred stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the deduction provided in section 247. If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), such new stock shall be considered as having been issued before October 1, 1942. If preferred stock is issued to refund or replace stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), is not itself preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the deduction provided in section 247.

(3) In the case of any preferred stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the deduction allowable under section 247, but the appropriate allocable portion of the total amount of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 247(b)(2) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of $100. On or after October 1, 1942, each of such bonds is retired in exchange for 1$\frac{1}{10}$ shares of preferred stock issued on or after October 1, 1942, and having a par value of $100 per share. Only $\frac{10}{11}$ of the dividends paid on the preferred stock thus issued

in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if preferred stock which is issued on or after October 1, 1942, has no par value but a stated value of $50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not preferred stock issued on or after October 1, 1942, was issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new preferred stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new preferred stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued before October 1, 1942, issues new preferred stock on October 1, 1954, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on November 1, 1954, such stock may be considered as having been issued to refund or replace bonds issued before October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Preferred stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued before October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued before October 1, 1942, if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939; or (ii) in a transaction to which section 371 (relating to insolvency reorganizations), or the corresponding provisions

of the Internal Revenue Code of 1939, is applicable; or (iii) in a transaction which is subject to the provisions of part VI of subchapter O (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission) or to the corresponding provisions of the Internal Revenue Code of 1939. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued before October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939, in a transaction to which section 371 or the corresponding provisions of the Internal Revenue Code of 1939 is applicable, or in a transaction which is subject to the provisions of part VI of subchapter O of this chapter or to the corresponding provisions of the Internal Revenue Code of 1939. The provisions of this paragraph, in addition, are applicable in case a corporation issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued before October 1, 1942, by reason of having been issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 247(b)(2), and no deduction will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 247(b)(2) and in this paragraph.

§1.248 Statutory Provisions; Organizational Expenditures.

SEC. 248. ORGANIZATIONAL EXPENDITURES.

(a) Election to Amortize.—The organizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary or his delegate), be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation (beginning with the month in which the corporation begins business).

(b) Organizational Expenditures Defined.—The term "organizational expenditures" means any expenditure which—

(1) is incident to the creation of the corporation;

(2) is chargeable to capital account; and

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

(c) Time for and Scope of Election.—The election provided by subsection (a) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The period so elected shall be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years. The election shall apply only with respect to expenditures paid or incurred on or after the date of enactment of this title.

§ 1.248–1 ELECTION TO AMORTIZE ORGANIZATIONAL EXPENDITURES.—(a) *In general.*—(1) Section 248(a) provides that a corporation may elect for any taxable year beginning after December 31, 1953, to treat its organizational expenditures, as defined in subsection (b) of section 248 and in paragraph (b) of this section, as deferred expenses. A corporation which exercises such election must, at the time it makes the election, select a period of not less than 60 months, beginning with the month in which it began business, over which it will amortize its organizational expenditures. The period selected by the corporation may be equal to or greater, but not less, than 60 months, but in any event it must begin with the month in which the corporation began business. The organizational expenditures of the corporation which are treated as deferred expenses under the provisions of section 248 and this section shall then be allowed as a deduction in computing taxable income ratably over the period selected by the taxpayer. The period selected by the taxpayer in making its election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(2) If a corporation exercises the election provided in section 248(a), such election shall apply to all of its expenditures which are organizational expenditures within the meaning of subsection (b) of section 248 and paragraph (b) of this section. The election shall apply, however, only with respect to expenditures incurred before the end of the taxable year in which the corporation begins business (without regard to whether the corporation files its returns on the accrual or cash method of accounting or whether the expenditures are paid in the taxable year in which they are incurred), if such expenditures are paid or incurred on or after August 16, 1954 (the date of enactment of the Internal Revenue Code of 1954).

(3) The deduction allowed under section 248 must be spread over a period beginning with the month in which the corporation begins business. The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case.

The words "begins business," however, do not have the same meaning as "in existence." Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

(b) *Organizational expenditures defined.*—(1) Section 248(b) defines the term "organizational expenditures." Such expenditures, for purposes of section 248 and this section, are those expenditures which are directly incident to the creation of the corporation. An expenditure, in order to qualify as an organizational expenditure, must be (i) incident to the creation of the corporation, (ii) chargeable to the

capital account of the corporation, and (iii) of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. An expenditure which fails to meet each of these three tests may not be considered an organizational expenditure for purposes of section 248 and this section.

(2) The following are examples of organizational expenditures within the meaning of section 248 and this section: legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings, terms of original stock certificates, and the like; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to State of incorporation.

(3) The following expenditures are not organizational expenditures within the meaning of section 248 and this section:

(i) Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees, and printing costs. This is so even where the particular issue of stock to which the expenditures relate is for a fixed term of years;

(ii) Expenditures connected with the transfer of assets to a corporation.

(4) Expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation, are not organizational expenditures within the meaning of section 248 and this section.

(c) *Time and manner of making election.*—The election provided by section 248(a) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year in which it begins business. Such taxable year must be one which begins after December 31, 1953. The return and statement must be filed not later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the taxpayer begins business. The statement shall set forth the description and amount of the expenditures involved, the date such expenditures were incurred, the month in which the corporation began business, and the number of months (not less than 60 and beginning with the month in which the taxpayer began business) over which such expenditures are to be deducted ratably.

Deferred Compensation, Etc.

PENSION, PROFIT-SHARING, STOCK BONUS PLANS, ETC.

§ 1.401 Statutory Provisions; Qualified Pension, Profit-Sharing, and Stock Bonus Plans.

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

(a) Requirements for Qualification.—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for con-

tributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

(3) if the trust, or two or more trusts, or the trust or trusts and annuity plan or plans are designated by the employer as constituting parts of a plan intended to qualify under this subsection which benefits either—

(A) 70 percent or more of all the employees, or 80 percent or more of all the employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan, excluding in each case employees who have been employed not more than a minimum period prescribed by the plan, not exceeding 5 years, employees whose customary employment is for not more than 20 hours in any one week, and employees whose customary employment is for not more than 5 months in any calendar year, or

(B) such employees as qualify under a classification set up by the employer and found by the Secretary or his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees;

and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(5) A classification shall not be considered discriminatory within the meaning of paragraph (3)(B) or (4) merely because it excludes employees the whole of whose remuneration constitutes "wages" under section 3121(a)(1) (relating to the Federal Insurance Contributions Act) or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits of or on behalf of the employees under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of such employees, or merely because the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" by section 3121(a)(1) differ from the contributions or benefits based on employee's remuneration not so excluded, or differ because of any retirement benefits created under State or Federal law.

(6) A plan shall be considered as meeting the requirements of paragraph (3) during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

(b) Certain Retroactive Changes in Plan.—A stock bonus, pension, profit-sharing, or annuity plan shall be considered as satisfying the requirements of paragraphs (3), (4), (5), and (6) of subsection (a) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put in effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

(c) Cross Reference.—For exemption from tax of a trust qualified under this section, see section 501(a).

§ 1.401–1 Qualified Pension, Profit-Sharing and Stock Bonus Plans.—(a) *Introduction.*—(1) Sections 401 through 404 relate to pension, profit-sharing, stock bonus, and annuity plans, and compensation paid under a deferred-payment plan. Section 401(a) pre-

scribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

(2) A qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer—

(i) In the case of a pension plan, to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to profits (see paragraph (b) (1) (i) of this section);

(ii) In the case of a profit-sharing plan, to enable employees or their beneficiaries to participate in the profits of the employer's trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a) (3) (B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan (see paragraph (b) (1) (ii) of this section); and

(iii) In the case of a stock bonus plan, to provide employees or their beneficiaries benefits similar to those of profit-sharing plans, except that such benefits are distributable in stock of the employer, and that the contributions by the employer are not necessarily dependent upon profits. If the employer's contributions are dependent upon profits, the plan may enable employees or their beneficiaries to participate not only in the profits of the employer, but also in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a) (3) (B) (see paragraph (b) (1) (iii) of this section).

(3) In order for a trust forming part of a pension, profit-sharing, or stock bonus plan to constitute a qualified trust under section 401(a), the following tests must be met:

(i) It must be created or organized in the United States, as defined in section 7701(a) (9), and it must be maintained at all times as a domestic trust in the United States;

(ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries (see paragraph (b) (2) through (5) of of this section);

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan;

(iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries (see § 1.401–2);

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees (see § 1.401–3); and

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees (see § 1.401–4).

(b) *General rules.*—(1) (i) A pension plan within the meaning of section 401 (a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forefeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401 (a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses.

(ii) A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant. A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under section 401 (a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. For the rules with respect to discrimination, see §§ 1.401–3 and 1.401–4. A profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

(iii) A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing

plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a plan is subject to the same requirements as a profit-sharing plan.

(iv) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(2) The term "plan" implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the case of a profit-sharing plan, it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees. In the event a plan is abandoned, the employer should promptly notify the district director, stating the circumstances which led to the discontinuance of the plan.

(3) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify as a plan for the exclusive benefit of employees even though other employees who are not shareholders are also included under the plan. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general if, by any device whatever, it discriminates either in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 401(a)(3), (4), and (5). Similarly, a stock bonus or profit-sharing plan is not a plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not only with the form of a plan but also with its effects in operation. For example, section 401(a)(5) specifies certain provisions which of themselves are not dis-

criminatory. However, this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(4) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as for example, in the Armed Forces of the United States. A plan covering only former employees may qualify under section 401(a) if it complies with the provisions of section 401(a)(3)(B), with respect to coverage, and section 401(a)(4), with respect to contributions and benefits, as applied to all of the former employees. The term "beneficiaries" of an employee within the meaning of section 401 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plan after the death of the employee.

(5)(i) No specific limitations are provided in section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, such a trust will be subject to tax under section 511 with respect to any "unrelated business taxable income" (as defined in section 512) realized by it from its investments. Furthermore, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute "prohibited transactions" within the meaning of section 503. See also the regulations under such sections.

(ii) Where the trust funds are invested in stock or securities of, or loaned to, the employer or other person described in section 503(c), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. The trustee shall report any of such investments on the return which under section 6033 it is required to file and shall with respect to any such investment furnish the information required by such return. See § 1.6033–1.

(c) *Portions of years.*—A qualified status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 401(a)(6) and § 1.401–3.

(d) *Plan of several employers.*—A trust forming part of a plan of several employers for their employees will be qualified if all the requirements are otherwise satisfied.

(e) *Returns.*—A trust which qualifies under section 401(a) and which is exempt under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. See § 1.6033–1. In case such a trust realizes any unrelated business taxable income, as defined in section 512, such trust is also required to file a return with respect to such income. See § 1.6012–2.

§ 1.401–2 IMPOSSIBILITY OF DIVERSION UNDER THE TRUST INSTRUMENT.—(a) *In general.*—(1) Under section 401(a)(2) a trust is not qualified unless under the trust instrument it is impossible (in the

taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries.

(2) As used in section 401(a)(2), the pharse "if under the trust instrument it is impossible" means that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. Although it is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries.

(3) As used in section 401(a)(2), the phrase "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) *Meaning of "liabilities."*—(1) The intent and purpose in section 401(a)(2) of the phrase "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust" is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust. A balance due to an "erroneous actuarial computation" is the surplus arising because actual requirements differ from the expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan and were made by a person competent to make such determinations in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation.

(2) The term "liabilities" as used in section 401(a)(2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension

plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute "liabilities" within the meaning of that term. It must be impossible for the employer (or other nonemployee) to recover any amounts other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all fixed and contingent obligations. Furthermore, the trust instrument must contain a definite affirmative provision to this effect, irrespective of whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and regardless of whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

§ 1.401–3 REQUIREMENTS AS TO COVERAGE.—(a) (1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be qualified unless it is part of a plan which satisfies the coverage requirements of section 401(a)(3). The percentage requirements in section 401(a)(3)(A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(2) The application of section 401(a)(3)(A) may be illustrated by the following example:

Example. An employer adopts a plan at a time when he has 1,000 employees. The plan provides that all full-time employees who have been employed by him for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires participating employees to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been employed for a period of two years. Fifty of the employees were seasonal employees whose customary employment did not exceed five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment did not exceed 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. The requirements of section 401(a)(3)(A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to whom the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	81+%
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 401(a)(3)(A), it may still qualify under section 401(a)(3)(B) provided always that (as required by section 401(a)(3) and (4)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, employees who receive the amounts allocated to their accounts before the expiration of such a period of time or the occurrence of such a contingency shall not be considered covered by a profit-sharing plan in determining whether the plan meets the coverage requirements of section 401(a)(3)(A) and (B). Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit-sharing plan for them, the employees who receive the shares immediately shall not, for the purpose of section 401, be considered covered by a profit-sharing plan.

(d) Section 401(a)(5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 401(a)(3)(B) even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided the effect of covering only such employees does not discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirements of section 401(a)(3)(B). Conversely, if a contributory plan is offered to all of the employees but the contributions required of the employee participants are so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(e)(1) Section 401(a)(5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of section 401(a)(3)(B) merely because all employees whose entire annual remuneration constitutes "wages" under section 3121(a)(1) (for purposes of the Federal Insurance Contributions Act) are excluded from the plan. A reference to section 3121(a)(1) for years after 1954 shall be deemed a reference to section 1426(a)(1) for years before 1955. This provision, in conjunction with section 401(a)(3)(B), is intended to permit the qualification of plans which supple-

ment the old-age and survivor insurance benefits under the Social Security Act. Thus, a classification which excludes all employees whose entire remuneration constitutes "wages" under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from wages under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in making his determination with respect to discrimination in classification under section 401(a)(3)(B), the Commissioner will consider whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). If, therefore, a classification of employees under a plan results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below any such salary amount or rate, it may be found to be discriminatory within the meaning of section 401(a)(3)(B). If, however, the relative or proportionate differences in benefits which result from such classification are approximately offset by the old-age and survivor insurance benefits which are provided by the Social Security Act and which are not attributable to employee contributions under the Federal Insurance Contributions Act, the plan will be considered to be properly integrated with the Social Security Act and will, therefore, not be considered discriminatory.

(2) In determining whether a plan is properly integrated with the Social Security Act, the total old-age and survivor insurance benefits with respect to an employee are considered to be 150 percent of the employee's old-age insurance benefits under such Act, and the proportion of such total benefits which is attributable to employee contributions is considered to be approximately 20 percent of such total benefits. These assumptions take into consideration the changes made by the Social Security Amendments of 1954 and the Social Security Amendments of 1956. Thus, for example, a classification of employees under a noncontributory pension or annuity plan established in 1956 which is limited to employees earning in excess of $4,200 a year will not be considered discriminatory within the meaning of section 401(a)(3)(B), if:

(i) Normal annual retirement benefits for any employee cannot exceed 37½ percent of his average annual compensation in excess of $4,200, where average annual compensation is defined to mean the average annual compensation over the highest five consecutive years.

(ii) There are no benefits payable in case of death before retirement.

(iii) The normal form of retirement benefit is a straight life annuity, and if there are optional forms, the benefit payments are adjusted so that the total value of the optional form is the same as the value of the normal form of retirement benefits.

(iv) Normal retirement benefits for employees who reach normal retirement age before completion of 15 years of service with the employer cannot exceed $2\frac{1}{2}$ percent of average annual compensation in excess of $4,200 for each year of service.

(v) Normal retirement age is not lower than age 65 for men and not lower than age 60 for women.

(vi) Benefits payable in case of retirement or severance of employment before normal retirement age cannot exceed the actuarial equivalent of that proportion of the maximum normal retirement benefits, which might be provided in accordance with subdivisions (i) through (v) of this subparagraph, earned to the date of actual retirement or severance, where such proportion is determined by the ratio that the actual number of years of service of the employee at retirement or severance bears to the total number of years of service he would have had if he had remained in service until normal retirement age.

In the case of a plan limited to employees earning over $4,200 a year but providing different benefits, or providing benefits related to years of service, or providing benefits purchasable by stated employer contributions, or under which the employees contribute, or providing a combination of the foregoing variations, the plan will be considered to be properly integrated only if, as determined by the Commissioner, the benefits provided thereunder by employer contributions cannot exceed in value the benefits described in the example. Similar principles will govern in determining whether a plan is properly integrated if it is limited to employees whose compensation exceeds a stated level other than $4,200 a year, or if it bases benefits on contributions or compensations in excess of such a level, or if it provides for an offset of benefits otherwise payable under the plan on account of old-age and survivor insurance benefits. In the case of a profit-sharing or stock bonus plan which is limited to employees whose compensation is in excess of a stated level, or which bases contributions on compensation in excess of a stated level, similar principles will govern in determining whether the plan is discriminatory, provided that the employer does not also have in existence a pension or annuity plan which is integrated with old-age and survivor insurance benefits and which provides for employer contributions or benefits based upon all or part of the same compensation considered under the profit-sharing or stock bonus plan. In the case of a plan which is properly integrated with old-age and survivor insurance benefits as in effect before the Social Security Amendments of 1954, and which is limited to employees earning in excess of a stated level, no adjustment is required merely because of the changes made by such Amendments.

(3) A plan supplementing the Social Security Act and excluding all employees whose entire annual remuneration constitutes "wages" under section 3121(a)(1) will not, however, be deemed discriminatory merely because, for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month.

(4) Similar considerations, to the extent applicable in any case, will govern classifications under a plan supplementing the benefits provided by other Federal or State laws. See section 401(a)(5).

§ 1.401-3(e)(3)

(f) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 401(a)(3), in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 401(a).

(g) It is provided in section 401(a)(6) that a plan will satisfy the requirements of section 401(a)(3), if on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 401(a)(3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 401(a)(3).

§ 1.401–4 Discrimination as to Contributions or Benefits.—(a)(1)(i) In order to qualify under section 401(a), a trust must not only meet the coverage requirements of section 401(a)(3), but, as provided in section 401(a)(4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan.

(ii) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, any amount allocated to an employee which is withdrawn before the expiration of such a period of time or the occurrence of such a contingency shall not be considered in determining whether the contributions under the plan discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. Thus, in case a plan permits employees to receive immediately the whole or any part of the amounts allocated to their accounts, or to have the whole or any part of such amounts paid to a profit-sharing plan for them, any amounts which are received immediately shall not, for the purpose of section 401, be considered contributed to a profit-sharing plan.

(iii) Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see paragraph (b)(1)(i) of § 1.401–1.

(2)(i) Section 401(a)(5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 401(a)(3) or (4). See § 1.401–3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular

rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act differ from the contributions or benefits based on any excess of such annual compensation over such part.

(ii) The exceptions specified in section 401(a)(5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits.

(iii) Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of an allocation formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes all employees whose entire remuneration constitutes wages under section 3121(a)(1) (relating to the Federal Insurance Contributions Act), or a plan under which the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" under such Act differs from the contributions or benefits based on that part of the employee's remuneration which is not so excluded, or a plan under which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 401(a).

(c) Although a plan may provide for termination at will by the employer, this will not of itself prevent a trust from being a qualified trust. However, in certain cases that fact may necessitate some provision in the plan which will preclude such termination from effecting the prohibited discrimination. This may occur where, for example, certain officers or highly compensated employees are at the inception of the plan within a few years of retirement age and the operation of the plan will fund and vest their benefits in a short period, thus resulting in such discrimination in favor of such officers or highly compensated employees.

§ 1.401–5 Period for Which Requirements of Section 401(a)(3), (4), (5), and (6) Are Applicable.—A pension, profit-sharing, stock bonus, or annuity plan shall be considered as satisfying the requirements of section 401(a)(3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all the provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus, if an employer in 1954 adopts such a plan as of January 1, 1954, and makes a return on the basis of the calendar year, he will have until March 15, 1955, to amend his plan so as to make it satisfy the

requirements of section 401(a)(3), (4), (5), and (6) for the calendar year 1954 provided that by March 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1954, the effective date of the plan. If an employer is on a fiscal year basis, for example, April 1 to March 31, and in 1954 adopts such a plan effective as of April 1, 1954, he will have until June 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a)(3), (4), (5), and (6) for the fiscal year beginning April 1, 1954, provided that by June 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to April 1, 1954, the effective date of the plan. It should be noted that under section 401(b) the period in which a plan may be amended to qualify under section 401(a) ends before the date on which taxpayers other than corporations are required to file income tax returns. See section 6072.

§ 1.402(a) Statutory Provisions; Taxability of Beneficiary of Employees' Trust; Exempt Trust.

SEC. 402. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST.

(a) Taxability of Beneficiary of Exempt Trust.—

(1) General rule.—Except as provided in paragraph (2), the amount actually distributed or made available to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities) except that section 72(e)(3) shall not apply. The amount actually distributed or made available to any distributee shall not include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee. Such net unrealized appreciation and the resulting adjustments to basis of such securities shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(2) Capital gains treatment for certain distributions.—In the case of an employees' trust described in section 401(a), which is exempt from tax under section 501(a), if the total distributions payable with respect to any employee are paid to the distributee within 1 taxable year of the distributee on account of the employee's death or other separation from the service, or on account of the death of the employee after his separation from the service, the amount of such distribution, to the extent exceeding the amounts contributed by the employee (determined by applying section 72(f)), which employee contributions shall be reduced by any amounts theretofore distributed to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. Where such total distributions include securities of the employer corporation, there shall be excluded from such excess the net unrealized appreciation attributable to that part of the total distributions which consists of the securities of the employer corporation so distributed. The amount of such net unrealized appreciation and the resulting adjustments to basis of the securities of the employer corporation so distributed shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

(3) Definitions.—For purposes of this subsection—

(A) The term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form.

(B) The term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in section 421(d)(2) and (3)) of the employer corporation.

(C) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service, or on account of his death after separation from the service.

§ 1.402(a)-1 Taxability of Beneficiary Under a Trust Which Meets the Requirements of Section 401(a).—(a) *In general.*—(1)(i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter.

(ii) The provisions of section 402(a) relate only to a distribution by a trust described in section 401(a) which is exempt under section 501(a) for the taxable year of the trust in which the distribution is made. The distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities), except that section 72(e)(3) (relating to the treatment of certain lump sums) shall not apply, and except that certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Furthermore, the exclusion provided by section 105(d) is applicable to a distribution from a trust described in section 401(a) and exempt under section 501(a) if such distribution constitutes wages or payments in lieu of wages for a period during which an employee is absent from work on account of a personal injury or sickness (see section 105 and the regulations thereunder).

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value. For example, where a United States savings bond which was purchased by a trustee in its own name later is distributed by such trust, it shall be taken into account at its redemption value at the time of distribution and such redemption value shall be the distributee's basis for the bond for the purpose of determining the extent to which income is realized upon its ultimate redemption.

(iv) If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years under section 501(a) (or under section 165(a) of the Internal Revenue Code of 1939 for years to which such section was applicable), the contributions of the employer which were includible in the gross in-

come of the employee for the taxable year when made shall, in accordance with section 72(f), also be treated as part of the consideration paid by the employee.

(v) If the trust is not exempt at the time the distribution is received by or made available to the employee, see section 402(b) and paragraph (b) of § 1.402(b)-1.

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. If, however, the contract distributed by such an exempt trust is a retirement income, endownment, or other life insurance contract and is distributed after October 26, 1956, the entire cash value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds).

(3)(i) If a trust described in section 401(a) and exempt under section 501(a) purchases under the plan retirement income, endowment, or other contracts providing life insurance protection, payable upon the death of the employee participants, and either—

(*a*) The proceeds of such life insurance are payable to a beneficiary of the employee participant, other than the trust, or

(*b*) In case such proceeds are payable to the trust, by the terms of the plan the trustee is required to pay over all of such proceeds to a beneficiary of the employee participant,

then, the portion of the premiums paid for the life insurance protection provided under such contracts from either the contributions of the employer or earnings of the trust will constitute income to the employee for the year or years in which the contributions or earnings are applied toward the purchase of such life insurance. If the amount payable upon death at any time during the year exceeds the cash value of the insurance policy at the end of the year, the entire amount of such excess will be considered current life insurance protection. The cost of such insurance will be considered to be a reasonable net premium cost, as determined by the Commissioner, for such amount for the appropriate period. The amount thus to be included in the gross income of the employee under this subdivision shall be considered as premiums or other consideration paid or contributed by the employee only with respect to any benefits attributable to the contract providing the life insurance protection.

(ii) The determination of the cost of life insurance protection may be illustrated by the following example:

Example. A policy purchased under a qualified plan for an employee provides an annuity of $100 per month upon retirement

at age 65, with a minimum death benefit of $10,000. The insurance payable if death occurred in the first year would be $10,000. The cash value at the end of the first year is 0. The net insurance is therefore $10,000 minus 0, or $10,000. Assuming that the Commissioner has determined that a reasonable net premium for the employee's age is $5.85 per $1,000, the premium for $10,000 of life insurance is therefore $58.50, and this is the amount to be reported as income by the employee for the year. The balance of the premium is the amount contributed for the annuity, which is not taxable to the employee under a plan meeting the requirements of section 401(a), except as provided under section 402(a). Assuming that the cash value at the end of the second year is $500, the net insurance would then be $9,500 for the second year. With a net 1-year term rate of $6.30 for the employee's age in the second year, the amount to be reported as income to the employee would be $59.85.

(iii) This subparagraph shall not apply if the thrust has a right under any circumstances to retain any part of the proceeds of the life insurance contract. But see subparagraph (4)(iv) relating to the taxability of the distribution of such proceeds to a beneficiary.

(4)(i) In case a trust described in section 401(a) and exempt under section 501(a) either—

(*a*) Has purchased a retirement income, endowment, or other life insurance contract, and the employee either paid the cost of the insurance or was taxable on the cost of the insurance under subparagraph (3) of this paragraph, or

(*b*) Has purchased an annuity contract, the amounts payable under any such contract by reason of the death of the employee are taxable under the rules of subdivision (ii) of this subparagraph, except in the case of a joint and survivor annuity.

(ii)(*a*) In the case of an annuity contract, the death benefit is the accumulation of the premiums (plus earnings thereon) which is intended to fund pension or other deferred benefits under a pension or profit-sharing plan. Such death benefits are not in the nature of life insurance and are not excludable from gross income under section 101(a).

(*b*) In the case of a retirement income, endowment, or other life insurance contract under which there is a reserve accumulation which is intended to fund pension or other deferred benefits under a pension or profit-sharing plan, such reserve accumulation constitutes the source of the cash value of the contract and approximates the amount of such cash value. The portion of the proceeds paid upon the death of the insured employee which is equal to the cash value immediately before death is not excludable from gross income under section 101(a). The remaining portion, if any, of the proceeds paid to the beneficiary by reason of the death of the insured employee—that is, the amount in excess of the cash value—constitutes current insurance protection and is excludable under section 101(a).

(*c*) The death benefit under an annuity contract, or the portion of the death proceeds under a retirement income, endowment, or other life insurance contract which is equal to the cash value of the contract immediately before death, constitutes a distribution from the trust

consisting in whole or in part of deferred compensation and is taxable to the beneficiary in accordance with section 402(a) and the provisions of this paragraph, except to the extent that the limited exclusion from income provided in section 101(b) is applicable.

(*d*) In the case of a retirement income, endowment, or other life insurance contract under which the benefits are paid at a date or dates later than the death of the employee, section 101(d) is applicable only to the portion of the benefits which is attributable to the amount excludable under section 101(a). The portion of such benefits which is attributable to the cash value of the contract immediately before death is taxable under section 72 (relating to annuities), and in such case, any amount excludable under section 101(b) is treated as additional consideration paid by the employee in accordance with section 101(b)(2)(D).

(iii) The application of the rules under subdivision (ii) with respect to the taxability of proceeds of a retirement income, endowment, or other life insurance contract paid by reason of the death of an insured employee who has paid no contributions under the plan is illustrated by the following examples:

Example (*1*).

Total face amount of the contract payable in a lump-sum at time of death	$25,000
Cash value of the contract immediately before death	11,000
Excess over cash value, excludable under section 101(a)	$14,000
Cash value subject to limited exclusion under section 101(b)	$11,000
Excludable under section 101(b) (assuming that there is no other death benefit paid by or on behalf of any employer with respect to the employee)	5,000
Balance taxable in accordance with section 402(a)(2) (assuming a total distribution in one taxable year of the distributee)	$6,000
Portion of premiums taxed to employee under the provisions of subparagraph (3) of this paragraph and considered as contributions of the employee	940
Balance taxable as long-term capital gain	$5,060

Example (*2*). The facts are the same as in example (1), except that the contract provides that the beneficiary may elect within 60 days after the death of the employee either to take the $25,000 or to receive 10 annual installments of $3,000 each, and the beneficiary elects to receive the 10 installments. In addition, the employee's rights to the cash value immediately before his death were forfeitable at least to the extent of $5,000. Section 101(d) is applicable to the amount excludable under section 101(a), that is, $14,000. The portion of each annual installment of $3,000 which is attributable to this $14,000 is determined by allocating each installment in accordance with the ratio which this $14,000 bears to the total amount which was payable at death ($25,000). Accordingly, the portion of each annual installment which is subject to section 101(d) is $1,680 (14/25 of $3,000), of which $1,400 (1/10 of $14,000) is excludable under section 101(a), and the remaining $280 is includible in the

gross income of the beneficiary. However, if the beneficiary is a surviving spouse as defined in section 101(d)(3), the exclusion provided by section 101(d)(1)(B) is applicable to such $280. The remaining portion of each annual $3,000 installment, $1,320, is attributable to the cash value of the contract and is treated under section 72, as follows:

Amount actually contributed by the employee	00
Amount considered contributed by employee by reason of section 101(b)	$5,000
Portion of premiums taxed to employee under the provisions of subparagraph (3) of this paragraph and considered as contributions of the employee	940
Investment in the contract	$5,940
Expected return, 10×$1,320	$13,200
Exclusion ratio, $5,940÷$13,200	.45
Annual exclusion, .45×$1,320	$594

Accordingly, $594 of the $1,320 portion of each annual installment is excludable each year under section 72, and the remaining $726 is includible. Thus, if the beneficiary is not a surviving spouse, a total of $1,006 ($280 plus $726) of each annual $3,000 installment is includible in income each year. If the beneficiary is a surviving spouse, and can exclude all of the $280 under section 101(d)(1)(B), the amount includible in gross income each year is $726 of each annual $3,000 installment.

(iv) If an employee neither paid the total cost of the life insurance protection provided under a retirement income, endowment, or other life insurance contract, nor was taxable under subparagraph (3) of this paragraph with respect thereto, no part of the proceeds of such a contract which are paid to the beneficiaries of the employee as a death benefit is excludable under section 101(a). The entire distribution is taxable to the beneficiaries under section 402(a) except to the extent that a limited exclusion may be allowable under section 101(b).

(5) If pension or annuity payments or other benefits are paid or made available to the beneficiary of a deceased employee or a deceased retired employee by a trust described in section 401(a) which is exempt under section 501(a), such amounts are taxable in accordance with the rules of section 402(a) and this section. In case such amounts are taxable under section 72, the "investment in the contract" shall be determined by reference to the amount contributed by the employee and by applying the rules of sections 72(c), 72(f), 101(b)(2)(D), and subparagraph (3) of this paragraph. In case the amounts paid to, or includible in the gross income of, the beneficiaries of the deceased employee or deceased retired employee constitute a distribution to which subparagraph (6) of this paragraph is applicable, the extent to which the distribution is taxable is determined by reference to the contributions of the employee, by reference to any prior distributions which were excludable from gross income as a return of employee contributions, and by applying the rules of sections 72(f), 101(b), and subparagraph (3) of this paragraph.

(6)(i) If the total distributions payable with respect to any employee under a trust described in section 401(a) which in the year of distribution is exempt under section 501(a) are paid to, or includible

in the gross income of, the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, or death after such separation from service, the amount of such distribution, to the extent it exceeds the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The total distributions payable are includible in the gross income of the distributee within one taxable year if they are made available to such distributee and the distributee fails to make a timely election under section 72(h) to receive an annuity in lieu of such total distributions. For rules relating to the treatment of such total distributions in the case of a nonresident alien individual, see sections 871 and 1441 and the regulations thereunder. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72(f), 101(b), and subparagraph (3) of this paragraph, reduced by any amounts theretofore distributed to him which were excludable from gross income as a return of employee contributions. See, however, paragraph (b) of this section for rules relating to the exclusion of amounts representing net unrealized appreciation in the value of securities of the employer corporation.

(ii) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service or on account of his death after separation from the service. Thus, distributions made before a total distribution (for example, annuity payments received by the employee after retirement), will not defeat application of the capital gains treatment with respect to the total distributions received by a beneficiary upon the death of the employee after retirement. However, a distribution on separation from service will not receive capital gains treatment unless it constitutes the total amount in the employee's account at the time of his separation from service. If the total amount in the employee's account at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the distributee within one taxable year of the distributee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount, attributable to the last year of service, is credited to the account of the employee and distributed.

(iii) If an employee retires and commences to receive an annuity but subsequently, in some succeeding taxable year, is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlment paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(iv) If the "total distributions payable" are paid or includible in the gross income of several distributees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. The total distributions payable are paid within one taxable year of the distributees when, for example,

a portion of such total is distributed in cash to one distributee and the balance is used to purchase an annuity contract which is distributed to the other distributee. However, if the share of any distributee is not paid or includible in his gross income within the same taxable year in which the shares of the other distributees are paid or includible in their gross income, none of the distributees is entitled to the capital gains treatment, since the total distributions payable are not paid or includible in the distributees' gross income within one taxable year. For example, if the total distributions payable are made available to each of two distributees and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share in installment payments from the trust, the capital gains treatment does not apply to either distributee.

(v) For regulations as to certain plan terminations, see § 1.402(e)-1.

(b) *Distributions including securities of the employer corporation.*—(1) *In general.*—(i) If a trust described in section 401(a) which is exempt under section 501(a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the following extent:

(*a*) If the distribution constitutes a total distribution to which the rules of paragraph (a)(6) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(*b*) If the distribution is other than a total distribution to which paragraph (a)(6) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludable under the rules of (*a*) and (*b*) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction. However, if the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, such excess shall constitute a long-term or short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 402(a) and of this section, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a

parent or subsidiary corporation (as defined in section 421(d)(2) and (3), relating to employee stock options) of the employer corporation.

(2) *Determination of net unrealized appreciation.*—(i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the cost or other basis of such security to the trust shall be computed in accordance with whichever of the following rules is applicable:

(*a*) If a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or other basis of such security to the trust is reflected in the account of such employee, such cost or other basis shall be used.

(*b*) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(*c*) In a case where neither (*a*) nor (*b*) of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(*d*)(*1*) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(*2*) These methods of computing average cost may be illustrated by the following examples:

Example (*1*). A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1954 (the specified inventory date of the trust), the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is $100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1954	$101	$2, 020
40	Jan. 10, 1953	102	4, 080
20	Oct. 20, 1952	95	1, 900
80	--------------	----------	$8, 000

Example (*2*). B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 31, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1952, 1,000 shares of class E stock of the employer corporation. During the calendar year 1953 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is $52 computed as follows:

	Shares	Total cost	Average cost
On hand December 31, 1952	1,000	$50,000	$50
Distributed during 1953 at average cost of $50	100	5,000	
	900	$45,000	
Purchased during 1953	120	8,040	
On hand December 31, 1953	1,020	$53,040	$52

(3) *Unrealized appreciation attributable to employee contributions.*—In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer corporation which is attributable to contributions made by an employee:

(i) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in accordance with the rules in subparagraph (2) of this paragraph;

(ii) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(iii) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the rules of subparagraph (2) of this paragraph which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(iv) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in subparagraph (2)(ii) (*a*), (*b*), (*c*), or (*d*) of this paragraph, whichever is applicable. Thus, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such allocation is inconsistent with the terms of the plan or trust.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the trust of $100, consisting of employee contributions in the amount of $60 and employer contributions in the amount of $40, and on the date of distribution has a fair market value of $180. The portion of the net unrealized appreciation attributable to the

contributions of the employee with respect to each of the shares of stock is $48 computed as follows:

(1) Value of one share of stock on distribution date	$180
(2) Employee contributions	$60
(3) Employer contributions	40
(4) Total contributions	$100
(5) Net unrealized appreciation	$80
(6) Portion of net unrealized appreciation attributable to employee contributions, 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of $80 (item 5))	$48

(vi) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (v) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be $132 computed as follows:

(*a*) Employee contributions	$60
(*b*) Employer contributions (taxable as ordinary income in the year the securities were distributed)	40
(*c*) Portion of net unrealized appreciation attributable to employer contributions (item (5) minus item (6)) (taxable as ordinary income in the year the securities were distributed)	32
(*d*) Basis of stock	$132

(4) *Change in exempt status of trust.*—For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years before the year of distribution, see paragraph (a) of this section.

§ 1.402(b) STATUTORY PROVISIONS; TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST; NON-EXEMPT TRUST.

SEC. 402. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST. * * *

(b) TAXABILITY OF BENEFICIARY OF NON-EXEMPT TRUST.—Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of an employee for the taxable year in which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities) except that section 72(e) (3) shall not apply.

§ 1.402(b)-1 TREATMENT OF BENEFICIARY OF A TRUST NOT EXEMPT UNDER SECTION 501(a).—(a) *Taxation by reason of employer contributions.*—(1) Except as provided in section 402(d), any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a), shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable at the time the

contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made even though his interest becomes nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2) (i) An employee's beneficial interest in the contribution is nonforfeitable within the meaning of sections 402(b), 403(b), and 404(a)(5) at the time the contribution is made if there is no contingency under the plan which may cause the employee to lose his rights in the contribution. For example, if under the terms of a pension plan, an employee upon termination of his services before the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is obligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable.

(ii) On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from, or to be provided by, contributions made by the employer if his services should be terminated before retirement, his beneficial interest in such contributions is forfeitable.

(iii) The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provided only that the employee is alive on the dates the annuity payments are due, the employee's right in the employer's contributions are nonforfeitable.

(b) *Taxation of distributions from trust not exempt under section 501(a).*—Any amount actually distributed or made available to any distributee by an employees' trust which is not exempt under section 501(a) for the taxable year of the trust in which the distribution is made shall be taxable in the year in which so distributed or made available, under section 72 (relating to annuities), except that section 72(e)(3) shall not apply. If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution, and such value is includible in the gross income of the distributee at the time of the distribution to the extent that such value exceeds the investment in the contract determined by applying sections 72 and 101(b). The distributions by such an employees' trust shall be taxed as provided in section 72, whether or not the employee's rights to the contributions were nonforfeitable when the contributions were made or at any time thereafter. For rules relating to the treatment of employer contributions to a nonexempt trust as part of the consideration paid by the employee, see section 72(f). For rules relating to the treatment of the limited

exclusion allowable under section 101(b)(2)(D) as additional consideration paid by the employee, see the regulations under that section.

§ 1.402(c) Statutory Provisions; Taxability of Beneficiary of Employees' Trust; Certain Foreign Situs Trusts.

SEC. 402. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST. * * *

(c) Taxability of Beneficiary of Certain Foreign Situs Trusts.—For purposes of subsections (a) and (b), a stock bonus, pension, or profit-sharing trust which would qualify for exemption from tax under section 501(a) except for the fact that it is a trust created or organized outside the United States shall be treated as if it were a trust exempt from tax under section 501(a).

§ 1.402(c)-1 Taxability of Beneficiary of Certain Foreign Situs Trusts.—Section 402(c) has the effect of treating, for purposes of section 402, the distributions from a trust which at the time of the distribution is located outside the United States in the same manner as distributions from a trust which is located in the United States. If the trust would qualify for exemption from tax under section 501(a) except for the fact that it fails to comply with the provisions of paragraph (a)(3)(i) of § 1.401-1, which restricts qualification to trusts created or organized in the United States and maintained here, section 402(a) and § 1.402(a)-1 are applicable to the distributions from such a trust. Thus, for example, a total distribution from such a trust is entitled to the long-term capital gains treatment of section 402(a)(2), except in the case of a nonresident alien individual (see sections 871 and 1441 and the regulations thereunder). However, if the plan fails to meet any requirement of section 401 and the regulations thereunder in addition to paragraph (a)(3)(i) of § 1.401-1, section 402(b) and § 1.402(b)-1 are applicable to the distributions from such a trust.

§ 1.402(d) Statutory Provisions; Taxability of Beneficiary of Employees' Trust; Annuities Under Agreements Entered Into Prior to October 21, 1942.

SEC. 402. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST. * * *

(d) Certain Employees' Annuities.—Nowithstanding subsection (b) or any other provision of this subtitle, a contribution to a trust by an employer shall not be included in the gross income of the employee in the year in which the contribution is made if—

(1) such contribution is to be applied by the trustee for the purchase of annuity contracts for the benefit of such employee;

(2) such contribution is made to the trustee pursuant to a written agreement entered into prior to October 21, 1942, between the employer and the trustee, or between the employer and the employee; and

(3) under the terms of the trust agreement the employee is not entitled during his lifetime, except with the consent of the trustee, to any payments under annuity contracts purchased by the trustee other than annuity payments.

The employee shall include in his gross income the amounts received under such contracts for the year received as provided in section 72 (relating to annuities) except that section 72(e)(3) shall not apply. This subsection shall have no application with respect to amounts contributed to a trust after June 1, 1949, if the trust on such date was exempt under section 165(a) of the Internal Revenue Code of 1939. For purposes of this subsection, amounts paid by an employer for the purchase of annuity contracts which are transferred to the trustee shall be deemed to be contributions made to a trust or trustee and contributions applied by the trustee for the purchase of an-

nuity contracts: the term "annuity contracts purchased by the trustee" shall include annuity contracts so purchased by the employer and transferred to the trustee: and the term "employee" shall include only a person who was in the employ of the employer, and was covered by the agreement referred to in paragraph (2), prior to October 21, 1942.

§ 1.402(d)-1 EFFECT OF SECTION 402(d).—(a) If the requirements of section 402(d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 501(a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as provided in section 72 (relating to annuities), except that section 72(e)(3) shall not apply. See paragraph (b) of § 1.403(b)-1. The intent and purpose of section 402(d) is to give those employees, covered under certain non-exempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts described in section 401(a) and exempt under section 501(a), except that the capital gains treatment referred to in section 402(a)(2) does not apply.

(b) Every person claiming the benefit of section 402(d) must be able to demonstrate to the satisfaction of the Commissioner that all of the provisions of such section are met. The taxpayer must produce sufficient evidence to prove:

(1) That, before October 21, 1942, he was employed by the particular employer making the contribution in question and was at such time definitely covered by a written agreement, entered into before October 21, 1942, between himself and the employer, or between the employer and the trustee of a trust established by the employer before October 21, 1942, and that the contribution by the employer was made pursuant to such agreement. The fact that an employee may have been potentially covered is not sufficient. Evidence that the employment was entered into, or the agreement executed, "as of" a date before October 21, 1942, or that the agreement or trust instrument which did not theretofore meet the requirements of section 402(d) was modified or amended after October 20, 1942, so as to come within the provisions of such section, will not satisfy the requirements of section 402(d).

(2) That such contribution, pursuant to the terms of such agreement, was to be applied for the purchase of an annuity contract for the taxpayer. In the case of a contribution by the employer of an annuity contract purchased by such employer and transferred by him to the trustee of the trust, evidence should be presented to prove that such contract was purchased for the taxpayer by the employer pursuant to the terms of a written agreement between the employer and the employee or between the employer and the trustee, entered into before October 21, 1942.

(3) That under the written terms of the trust agreement the taxpayer is not entitled during his lifetime, except with the consent of the trustee, to any payments other than annuity payments under the annuity contract or contracts purchased by the trustee or by the employer and transferred to the trustee, and that the trustee may grant or withhold such consent free from control

by the taxpayer, the employer, or any other person. However, such control will not be presumed from the fact that the trustee is himself an officer or employee of the employer. As used in section 402(d) the phrase "if * * * under the terms of the trust agreement the employee is not entitled" means that the trust instrument must make it impossible for the prohibited distribution to occur, whether by operation or natural termination of the trust, whether by power of revocation or amendment, other than with the consent of the trustee, whether by the happening of a contingency, by collateral arrangement, or any other means. It is not essential that the employer relinquish all power to modify or terminate the trust but it must be impossible, except with the consent of the trustee, for any payments under annuity contracts purchased by the trustee, or by the employer and transferred to the trustee, to be received by the taxpayer, directly or indirectly, other than as annuity payments.

(4) The nature and amount of such contribution and the extent to which income taxes have been paid thereon before January 1, 1949, and not credited or refunded.

(5) If it is claimed that section 402(d) applies to amounts contributed to a trust after June 1, 1949, the taxpayer must prove to the satisfaction of the Commissioner that the trust did not, on June 1, 1949, qualify for exemption under section 165(a) of the Internal Revenue Code of 1939. Where an employer buys an annuity contract which is transferred to the trustee, the date of the purchase of the annuity contract and not the date of the transfer to the trustee is the controlling date in determining whether or not the contribution was made to the trust after June 1, 1949.

§ 1.402(e) STATUTORY PROVISIONS; TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST; CERTAIN PLAN TERMINATIONS.

SEC. 402. TAXABILITY OF BENEFICIARY OF EMPLOYEES' TRUST. * * *

(e) CERTAIN PLAN TERMINATIONS.—For purposes of subsection (a)(2), distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of a stock bonus, pension, or profit-sharing plan of an employer which is a corporation, if the termination of the plan is incident to the complete liquidation, occurring before the date of enactment of this title, of the corporation, whether or not such liquidation is incident to a reorganization as defined in section 368(a), shall be considered to be distributions on account of separation from service.

§ 1.402(e)-1 CERTAIN PLAN TERMINATIONS.—Distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of an employees' trust described in section 401(a) which is exempt under section 501(a) shall be considered distributions on account of separation from service for purposes of section 402(a)(2) if the employer who established the trust is a corporation, and the termination of the plan is incident to the complete liquidation of the corporation before August 16, 1954, regardless of whether such liquidation is incident to a reorganization as defined in section 368.

§ 1.403(a) STATUTORY PROVISIONS; TAXATION OF EMPLOYEE ANNUITIES; QUALIFIED ANNUITY PLAN.

SEC. 403. TAXATION OF EMPLOYEE ANNUITIES.

(a) TAXABILITY OF BENEFICIARY UNDER A QUALIFIED ANNUITY PLAN.—

(1) GENERAL RULE.—Except as provided in paragraph (2), if an annuity contract is purchased by an employer for an employee under a plan with respect to which the employer's contribution is deductible under section 404(a)(2), or if an annuity contract is purchased for an employee by an employer described in section 501(c)(3) which is exempt from tax under section 501(a), the employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72(e)(3) shall not apply.

(2) CAPITAL GAINS TREATMENT FOR CERTAIN DISTRIBUTIONS.—

(A) GENERAL RULE.—If—

(i) an annuity contract is purchased by an employer for an employee under a plan which meets the requirements of section 401(a)(3), (4), (5), and (6);

(ii) such plan requires that refunds of contribution with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan; and

(iii) the total amounts payable by reason of an employee's death or other separation from the service, or by reason of the death of an employee after the employee's separation from the service, are paid to the payee within one taxable year of the payee,

then the amount of such payments, to the extent exceeding the amount contributed by the employee (determined by applying section 72(f)), which employee contributions shall be reduced by any amounts theretofore paid to him which were not includible in gross income, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months.

(B) DEFINITION.—For purposes of subparagraph (A), the term "total amounts" means the balance to the credit of an employee which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service.

§ 1.403(a)-1 TAXABILITY OF BENEFICIARY UNDER A QUALIFIED ANNUITY PLAN.—(a) An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid, whether or not his rights to the contract are forfeitable, if—

(1) The annuity contract is purchased under a plan with respect to which the amounts paid by the employer are deductible under section 404(a)(2), or

(2) The annuity contract is purchased under a plan which meets the requirements of section 404(a)(2) although the employer does not deduct the amounts paid for the contract under such section, or

(3) The annuity contract is purchased by an employer which is an organization described in section 501(c)(3) and exempt under section 501(a) provided the purchase of the annuity is merely a supplement to past or current compensation. For the purpose of this subparagraph, whether the purchase of an annuity contract is merely a "supplement to past or current compensation" is to be determined by all the surrounding facts and circumstances. One of the pertinent facts to be taken into consideration is the ratio of the

consideration paid by the employer for an employee's contract to the amount of his past or current compensation. For example, if the annual premium paid for an employee's contract is $1,000 and his annual salary is $10,000, the ratio indicates that the premium paid for the contract is merely a supplement to the employee's current compensation. If, however, an employee receives no current compensation, or the annual premiums paid for his annuity contract approximate his annual salary, the amount paid for his contract will be considered to be current compensation and taxable to the employee in the year in which it is paid by the employer. Other pertinent considerations are whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's annual salary, or whether it is purchased at his request in lieu of an increase in current compensation to which he otherwise might be entitled. In such cases, the amount paid for the contract shall also be considered to be current compensation.

(b) The amounts received by or made available to any employee referred to in paragraph (a) of this section under such annuity contract shall be included in gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities) except that section 72(e)(3) shall not apply, and except that certain total distributions described in section 403(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see § 1.403(a)-2.

(c) If upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under section 403(a) shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)-1.

(d) If under a qualified annuity plan a group contract providing group permanent life insurance protection is purchased for the employees, the same rules which are applicable when contracts providing life insurance protection are purchased by a trust described in section 401(a) and exempt under section 501(a), shall be applicable in the case of such a contract. For such rules, see paragraph (a)(2), (3), and (4) of § 1.402(a)-1. Section 403(a) is not applicable to premiums paid after October 26, 1956, for individual contracts providing life insurance protection for employees.

(e) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

§ 1.403(a)-2 Capital Gains Treatment for Certain Distributions.—(a) If the total amounts payable with respect to any employee for whom an annuity contract has been purchased by an employer under a plan which—

(1) Meets the requirements of section 401(a)(3), (4), (5), and (6), and

(2) Requires that refunds of contributions with respect to annuity

contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan,

are paid to, or includible in gross income of, the payee within one taxable year of the payee by reason of the employee's death or other separation from the service, or death after such separation from the service, such total payments, to the extent they exceed the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72(f), 101(b), and paragraph (d) of § 1.403(a)-1, reduced by any amounts theretofore distributed to him which were excludable from his gross income as a return of employee contributions. For example, if under an annuity contract purchased under a plan described in this section, the total distributions payable to the employee's widow are paid to her in the year in which the employee dies, in the amount of $8,000, and if $5,000 thereof is excludable under section 101(b), and if the employee made contributions of $600 and had received no payments, the remaining amount of $2,400 will be considered a gain from the sale or exchange of a capital asset held for more than six months.

(b) (1) The term "total amounts" means the balance to the credit of an employee with respect to all annuities under the annuity plan which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service. If an employee commences to receive annuity payments on retirement and then a lump sum payment is made to his widow upon his death, the capital gains treatment applies to the lump sum payment, but it does not apply to amounts received before the time the "total amounts" become payable. However, if the total amount to the credit of the employee at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the payee within one taxable year of the payee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount is credited to the employee and paid to the payee.

(2) If more than one annuity contract is received under the plan, the capital gains treatment does not apply to any amount received on the surrender thereof unless all contracts under the plan with respect to a particular employee are surrendered either at the time of the employee's death or other separation from the service or death after separation from the service. Thus, if an employee receives two contracts on separation from the service and surrenders one of them in the year of separation and receives payments under the other until his death, the capital gains treatment is applicable to the balance paid to his beneficiary on his death if paid within one taxable year of the beneficiary. The amount received by the employee on surrender of the contract in the year of his separation from the service, however, would not receive capital gains treatment since the balance to the credit of the employee with respect to all amounts under the plan did not become payable at that time.

(3) If an employee retires and commences to receive an annuity but subsequently in some succeeding taxable year, he is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(4) If the "total amounts" payable under all annuity contracts under the plan with respect to a particular employee are paid or includible in the gross income of several payees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. Thus, if the balance to the credit of a deceased employee under all annuity contracts provided under an annuity plan becomes payable to two payees, the capital gains treatment is applicable provided the "total amounts" payable are received by or includible in the gross income of both payees within the same taxable year. However, if the "total amounts" payable are made available to each payee and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share as an annuity, the capital gains treatment does not apply to either payee.

§ 1.403(b) Statutory Provisions; Taxation of Employee Annuities; Nonqualified Annuity.

SEC. 403. TAXATION OF EMPLOYEE ANNUITIES. * * *

(b) Taxability of Beneficiary Under a Nonqualified Annuity.—If an annuity contract purchased by an employer for an employee is not subject to subsection (a) and the employee's rights under the contract are nonforfeitable, except for failure to pay future premiums, the amount contributed by the employer for such annuity contract on or after such rights become nonforfeitable shall be included in the gross income of the employee in the year in which the amount is contributed. The employee shall include in his gross income the amounts received under such contract for the year received as provided in section 72 (relating to annuities) except that section 72(e) (3) shall not apply.

§ 1.403(b)–1 Taxability of Beneficiary Under a Nonqualified Annuity.—(a) Except as provided in section 402(d), if an employer purchases an annuity contract and if the amounts paid for the contract are not subject to paragraph (a) of § 1.403(a)–1, the amount of such contribution shall be included in the income of the employee for the taxable year during which such contribution is made if, at the time the contribution is made, the employee's rights under the annuity contract are nonforfeitable, except for failure to pay future premiums. If the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later, the amount of such contribution is not required to be included in the income of the employee at the time his rights under the contract become nonforfeitable. As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)–1. The amounts received by or made available to the employee under the annuity contract shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in

section 72 (relating to annuities) except that section 72(e)(3) shall not apply. For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(b) If an employer has purchased annuity contracts and transferred the same to a trust or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 402(d) (see paragraph (a) of § 1.402(d)-1), the amount so paid or contributed is not required to be included in the income of the employee, but any amount received by or made available to the employee under the annuity contract shall be includible in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities), except that section 72(e)(3) shall not apply. In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 72 unless the employee has paid income tax for any taxable year beginning before January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not credited or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 72.

§ 1.404(a) Statutory Provisions; Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan; General Rule.

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) General Rule.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income) but if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) Pension trusts.—In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), in an amount determined as follows:

(A) an amount not in excess of 5 percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but such amount may be reduced for future years if found by the Secretary or his delegate upon periodical examinations at not less than 5-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

(B) any excess over the amount allowable under subparagraph (A) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Secretary or his delegate, but if such remaining unfunded cost with respect to any 3 individuals is more than 50 percent of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

(C) in lieu of the amounts allowable under subparagraphs (A) and (B) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary or his delegate, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 percent of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan, as determined under regulations prescribed by the Secretary or his delegate, except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

(D) Any amount paid in a taxable year in excess of the amount deductible in such year under the foregoing limitations shall be deductible in the succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each such succeeding year and the maximum amount deductible for such year in accordance with the foregoing limitations.

(2) EMPLOYEES' ANNUITIES.—In the taxable year when paid, in an amount determined in accordance with paragraph (1), if the contributions are paid toward the purchase of retirement annuities and such purchase is a part of a plan which meets the requirements of section 401(a)(3), (4), (5), and (6), and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities.

(3) STOCK BONUS AND PROFIT-SHARING TRUSTS.—

(A) LIMITS ON DEDUCTIBLE CONTRIBUTIONS.—In the taxable year sharing trust, and if such taxable year ends within or with a taxable year of the trust with respect to which the trust is exempt under section 501(a), in an amount not in excess of 15 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit-sharing plan. If in any taxable year there is paid into the trust, or a similar trust then in effect, amounts less than the amounts deductible under the preceding sentence, the excess, or if no amount is paid, the amounts deductible, shall be carried forward and be deductible when paid in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any such succeeding taxable year shall not exceed 15 percent of the compensation otherwise paid or accrued during such succeeding taxable year to the beneficiaries under the plan. In addition, any amount paid into the trust in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this subparagraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this subparagraph shall not exceed 15 percent of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under the plan. The term "stock bonus or profit-sharing trust", as used in this subparagraph, shall not include any trust designed to provide benefits upon retirement and covering a period of years, if under the plan the amounts to be contributed by the employer can be determined actuarially as provided in paragraph (1). If the contributions are made to 2 or more stock bonus

or profit-sharing trusts, such trusts shall be considered a single trust for purposes of applying the limitations in this subparagraph.

(B) PROFIT-SHARING PLAN OF AFFILIATED GROUP.—In the case of a profit-sharing plan, or a stock bonus plan in which contributions are determined with reference to profits, of a group of corporations which is an affiliated group within the meaning of section 1504, if any member of such affiliated group is prevented from making a contribution which it would otherwise have made under the plan, by reason of having no current or accumulated earnings or profits or because such earnings or profits are less than the contributions which it would otherwise have made, then so much of the contribution which such member was so prevented from making may be made, for the benefit of the employees of such member, by the other members of the group, to the extent of current or accumulated earnings or profits, except that such contribution by each such other member shall be limited, where the group does not file a consolidated return, to that proportion of its total current and accumulated earnings or profits remaining after adjustment for its contribution deductible without regard to this subparagraph which the total prevented contribution bears to the total current and accumulated earnings or profits of all the members of the group remaining after adjustment for all contributions deductible without regard to this subparagraph. Contributions made under the preceding sentence shall be deductible under subparagraph (A) of this paragraph by the employer making such contribution, and, for the purpose of determining amounts which may be carried forward and deducted under the second sentence of subparagraph (A) of this paragraph in succeeding taxable years, shall be deemed to have been made by the employer on behalf of whose employees such contributions were made.

(4) TRUSTS CREATED OR ORGANIZED OUTSIDE THE UNITED STATES.—If a stock bonus, pension, or profit-sharing trust would qualify for exemption under section 501(a) except for the fact that it is a trust created or organized outside the United States, contributions to such a trust by an employer which is a resident, or corporation, or other entity of the United States, shall be deductible under the preceding paragraphs.

(5) OTHER PLANS.—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

(6) TAXPAYERS ON ACCRUAL BASIS.—For purposes of paragraphs (1), (2), and (3), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

(7) LIMIT OF DEDUCTION.—If amounts are deductible under paragraphs (1) and (3), or (2) and (3), or (1), (2), and (3), in connection with 2 or more trusts, or one or more trusts and an annuity plan, the total amount deductible in a taxable year under such trusts and plans shall not exceed 25 percent of the compensation otherwise paid or accrued during the taxable year to the persons who are the beneficiaries of the trusts or plans. In addition, any amount paid into such trust or under such annuity plans in any taxable year in excess of the amount allowable with respect to such year under the preceding provisions of this paragraph shall be deductible in the succeeding taxable years in order of time, but the amount so deductible under this sentence in any one such succeeding taxable year together with the amount allowable under the first sentence of this paragraph shall not exceed 30 percent of the compensation otherwise paid or accrued during such taxable years to the beneficiaries under the trusts or plans. This paragraph shall not have the effect of reducing the amount otherwise deductible under paragraphs (1), (2), and (3), if no employee is a beneficiary under more than one trust, or a trust and an annuity plan.

416926°—57——16

§ 1.404(a)-1 CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERED-PAYMENT PLAN; GENERAL RULE.—(a) (1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404(a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see § 1.404(a)-12).

(2) Section 404(a) does not apply to a plan which does not defer the receipt of compensation. Furthermore, section 404(a) does not apply to deductions for contributions under a plan which is solely a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare, or similar benefit plan, or a combination thereof. For example, if under a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan, and the deductibility of the contributions to it is determined under section 162. As to the deductibility of such contributions, see § 1.162-9.

(3) If, however, the contributions to a pension, profit-sharing, stock bonus, or other plan of deferred compensation can be used to provide any of the benefits referred to in subparagraph (2) of this paragraph, then, except as provided in section 404(c), section 404(a) applies to the entire contribution to the plan. Thus, if in the example described in subparagraph (2) of this paragraph, the employer's contribution on behalf of each employee is set up as a separate account, and if any amount which remains in an employee's account at the time of retirement is paid to him at such time, the deductibility of the contributions to the plan is determined under section 404(a). For the rules for determining whether the benefits referred to in subparagraph (2) of this paragraph can be included in a qualified pension or profit-sharing plan, see § 1.401-1(b).

(4) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a) (20).

(b) In order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What

constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 316. See also §§ 1.162–6 and 1.162–8. In addition to the limitations referred to above, deductions under section 404(a) are also subject to further conditions and limitations particularly provided therein.

(c) Deductions under section 404(a) are generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting. Exceptions are made in the case of overpayments as provided in paragraphs (1), (3), and (7) of section 404(a), and, as provided by section 404(a)(6), in the case of payments made by a taxpayer on the accrual method of accounting not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof). This latter provision is intended to permit a taxpayer on the accrual method to deduct such accrued contribution or compensation in the year of accrual, provided payment is actually made not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof), but this provision is not applicable unless, during the taxable year on account of which the contribution is made, the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year. See section 461 and the regulations thereunder. There is another exception in the case of certain taxpayers who are required to make additional contributions as a result of Public Law 74 (Eighty-fourth Congress) approved June 15, 1955, and the regulations thereunder.

§ 1.404(a)–2 INFORMATION TO BE FURNISHED BY EMPLOYER CLAIMING DEDUCTIONS.—(a) For the first taxable year for which a deduction from gross income is claimed under section 404(a)(1), (2), (3), or (7), the employer must file the following information (unless such information has been previously filed in accordance with the regulations under section 23(p) of the Internal Revenue Code of 1939) for each plan involved to establish that it meets the requirements of section 401(a) or 404(a)(2), and that deductions claimed do not exceed the amount allowable under paragraphs (1), (2), (3), and (7) of section 404(a), as the case may be:

(1) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, speci-

men copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(2) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise), the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable and a summary of the provisions and rules relating to—

(i) Employee eligibility requirements for participation in the plan,

(ii) Employee contributions,

(iii) Employer contributions,

(iv) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(v) The medium of funding (e. g., self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly insured, the medium of contributions and the kind of investments, and

(vi) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(3) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their nondeferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans):

(i) Name.

(ii) Whether an officer.

(iii) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(iv) Whether the principal duties consist in supervising the work of other employees.

(v) Year of birth.

(vi) Length of service for employer to the close of the year.

(vii) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components:

(*a*) Basic compensation and overtime pay,

(*b*) Other direct payments, such as bonuses and commissions,

(*c*) Compensation paid other than in cash, such as goods,

services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(viii) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under each other plan of deferred compensation.

(ix) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components:

(*a*) Amounts originally allocated in the year, and

(*b*) Amounts reallocated in the year.

(x) Amounts of employee contributions during the year under the plan,

(xi) If a pension or annuity plan,

(*a*) The retirement age and date and the form of the retirement benefit,

(*b*) The annual rate or amount of the retirement benefit, and

(*c*) The aggregate of all of the employee's contributions under the plan,

all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan.

(4) The following totals:

(i) Total nondeferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(ii) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto), less employee contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components:

(*a*) Amount originally allocated in the year, and

(*b*) Amount reallocated in the year.

(5) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(i) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.).

(ii) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subdivision (i) of this subparagraph.

(iii) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subdivision (i) or (ii) of this subparagraph.

(iv) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(v) All employees ineligible for coverage under the plan other than those employees included in subdivision (i), (ii), (iii), or (iv) of this subparagraph, specifying the reason applicable to the group.

(vi) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subdivisions (i) to (v), inclusive, of this subparagraph.

(vii) All employees eligible for coverage but not covered under the plan.

(viii) All employees covered under the plan.

(ix) All employees of the employer, which should be the sum of subdivisions (vi), (vii), and (viii) of this subparagraph.

If it is claimed that the requirements of section 401(a)(3)(A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(6) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(7) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held. Also a summary of the resulting costs or liabilities and adjustments for the year under the pension or annuity plan in sufficient detail to permit ready verification of the reasonableness thereof.

(8) A statement of the applicable limitations under section 404(a)(1), (2), (3), or (7) and an explanation of the method of determining such limitations and a summary of the data and computations necessary to determine the allowable deductions for the taxable year.

(9) A statement of the contributions paid in the taxable year, showing the date and amount of each payment. Also a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components:

(i) For contributions paid in the taxable year before giving effect to the provisions of paragraph (7) of section 404(a).

(ii) For contributions paid in prior taxable years beginning after December 31, 1941, in accordance with the carryover provisions of paragraphs (1) and (3) of section 404(a), before giving effect to the provisions of paragraph (7) thereof, and in accordance with the carryover provisions of section 404(d).

§ 1.404(a)–2(a)

(iii) Any reductions or increases in the deductions in accordance with the provisions of paragraph (7) of section 404(a).

(b) For taxable years subsequent to the year for which all of the applicable information under paragraph (a) of this section (or corresponding provisions of prior regulations) has been filed, information is to be filed only to the following extent:

(1) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in paragraph (a) (1), (2), or (7) of this section are based, a detailed statement explaining the change and its effect is to be filed only for the taxable year in which the change is put into effect. However, if there is no such change, unless otherwise requested by the district director, merely a statement that there is no such change is to be filed.

(2) The information specified in paragraph (a) (3) of this section which has been filed for a taxable year, unless otherwise requested by the district director and so long as the plan and the method and basis of allocations are not changed, is to be filed for subsequent years only to the extent of showing in the tabulation such information with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(3) The information specified in paragraph (a) (4), (5), (6), (8), and (9) of this section.

(c) If a deduction is claimed under section 404(a) (5) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the deduction is not allowable under the other paragraphs of section 404(a), that the amount paid is an ordinary and necessary expense or an expense for the production of income, and that the employees' rights to, or derived from, such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid.

(d) For the purpose of the information required by this section, contributions paid in a taxable year should include those deemed to be so paid in accordance with the provisions of section 404(a) (6) and should exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section, "taxable year" refers to the taxable year of the employer and, unless otherwise requested by the district director, a "year" which is not specified as a "taxable year" may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year with respect to which deductions are being claimed provided the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed except that, unless sooner requested by the district director, such information, other than that specified in paragraph (a) (4) (i) and (9) of

this section, may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

(e) In any case all the information and data required by this section must be filed in the office of the district director in which the employer files his tax returns and identified for association with the appropriate returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 401(a). The district director may, in addition, require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401 and may waive the filing of such information required herein which he finds unnecessary in a particular case.

(f) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

§ 1.404(a)–3 Contributions of an Employer to or Under an Employees' Pension Trust or Annuity Plan That Meets the Requirements of Section 401(a); Application of Section 404(a)(1).—(a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a) (1) or (2) if the further conditions provided therein are also satisfied. As used here, a "pension trust" means a trust forming part of a pension plan and an "annuity plan" means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. This section is also applicable to contributions to a foreign situs pension trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States. For the meaning of "pension plan" as used here, see paragraph (b)(1)(i) of § 1.401–1. Where disability pensions, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 404(a) (1) or (2). See paragraph (a)(3) of § 1.402(a)–1 as to taxability to employees of cost of incidental insurance protection. In order to be deductible under section 404(a)(1), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 501(a). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 501(a). See § 1.404(a)–8 as to conditions for deductions under section 404(a)(2) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section

404(a)(1). The limitations provided in section 404(a)(1) are, with an exception provided for certain years under subparagraph (A) thereof (see § 1.404(a)-4), based on the actuarial costs of the plan.

(b) In determining costs for the purpose of limitations under section 404(a)(1), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract, In no event shall costs for the purpose of section 404(a)(1) exceed costs based on assumptions and methods which are reasonable in view of the provisions and coverage of the plan, the funding medium, reasonable expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement (whether or not discounted) which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations, an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years. Unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost arising from experience in the next preceding taxable year which was more favorable than the assumptions on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) The amount of a contribution to a pension or annuity plan that is deductible under section 404(a)(1) or (2) depends upon the methods, factors, and assumptions which are used to compute the costs of the plan and the limitation of section 404(a)(1) which is applied. Since the amount that is deductible for one taxable year may affect the amount that is deductible for other taxable years, the methods, factors, and assumptions used in determining costs and the method of determining the limitation which have been used for determining the deduction for a taxable year for which the return has been filed shall not be changed for such taxable year, except when the Commissioner determines that the methods, factors, assumptions, or limitations were not proper, or except when a change is necessitated by reason of the use of different methods, factors, assumptions, or limitations for another taxable year. However, different methods, factors, and assumptions, or a different method of determining the limitation, if they are proper, may be used in determining the deduction for a subsequent taxable year. In any case, see paragraphs (a)(7) and (8) and (b)(1) and (3) of § 1.404(a)-2 for the information which must be submitted regarding the methods, factors, assumptions, and limitations.

(d) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under the plan are deductible by the employer under section 162 (relating to trade or business expenses), or 212 (relating

to expenses for production of income) to the extent that they are ordinary and necessary.

(e) In case deductions are allowable under section 404(a)(3) as well as under section 404(a)(1) or (2), the limitations under section 404(a)(1) and (3) are determined and applied without giving effect to the provisions of section 404(a)(7) but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

§ 1.404(a)–4 Pension and Annuity Plans; Limitations Under Section 404(a)(1)(A).—(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), the initial limitation under section 404(a)(1)(A) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year for which the 5-percent figure is not reduced as provided in this section. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return an actuarial certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year. Such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404(a)(1)(C). Whenever requested by the district director, a similar certification and statement shall be submitted for the year or years specified in such request. The district director will make periodical examinations of such data at not less than 5-year intervals. Based upon such examinations the Commissioner will reduce the limitation under section 404(a)(1)(A) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the district director with a request for a change in the limitation.

(c) For the purpose of limitations under section 404(a)(1)(A), "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that

qualifies under section 404(a)(2). Where two or more pension or annuity plans cover the same employee, under section 404(a)(1)(A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5-percent limitation applies, deductions under section 404(a)(1)(A) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under section 404(a)(1)(A) even where these are greater than the applicable limitations under section 404(a)(1)(B) or section 404(a)(1)(C).

§ 1.404(a)-5 PENSION AND ANNUITY PLANS; LIMITATIONS UNDER SECTION 404(a)(1)(B).—(a) Subject to the applicable general conditions and limitations (see § 1.404(a)-3), under section 404(a)(1)(B), deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost is attributable, the remaining unfunded cost attributable to such individuals shall be distributed evenly over a period of at least five taxable years.

(b) The statutory limitation for any taxable year under section 404(a)(1)(B) is any excess of the amount of the costs described in paragraph (a) of this section for the year over the amount allowable as a deduction under section 404(a)(1)(A).

(c) For this purpose, such excess, adjusted for prior experience, may be computed for each year as follows, all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under section 404(a)(1)(B) for the year by multiplying the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under section 404(a)(1)(B) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 1.404(a)-3) and provided subparagraph (5) of this paragraph is not less than five times the annual rate of compensation in effect at the beginning of the year.

(d) Instead of determining the excess deductible under section 404(a)(1)(B) by the method shown in paragraph (c), such excess may be based upon costs determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan, the funding medium, and other applicable considerations.

§ 1.404(a)-6 Pension and Annuity Plans; Limitations Under Section 404(a)(1)(C).—(a) Subject to the applicable general conditions and limitations (see § 1.404(a)-3), in lieu of amounts deductible under the limitations of section 404(a)(1)(A) and section 404(a)(1)(B), deductions may be allowed under section 404(a)(1)(C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. "Normal cost" for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(b) The limitation under section 404(a)(1)(C) for any taxable year is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. For this purpose the normal costs may be determined by any generally accepted actuarial method and may be expressed either as (1) the aggregate of level amounts with respect to each employee covered under the plan, (2) a level percentage of payroll with respect to each employee covered under the plan, or (3) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided,

in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but it is subject to adjustments for prior favorable experience. See § 1.404(a)–3. In any case, past service or supplementary costs shall not be included in the limitation for any year in which the amount required to fund fully or to purchase such past service or supplementary credits has been deducted, since no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

§ 1.404(a)–7 PENSION AND ANNUITY PLANS; CONTRIBUTIONS IN EXCESS OF LIMITATIONS UNDER SECTION 404(a)(1); APPLICATION OF SECTION 404(a)(1)(D).—Where contributions paid by an employer in a taxable year to or under a pension or annuity plan exceed the limitations applicable under section 404(a)(1) but otherwise satisfy the conditions for deduction under section 404(a)(1) or (2), then in accordance with section 404(a)(1)(D), the excess contributions are carried over and are deductible in succeeding taxable years in order of time to the extent of the difference between the amount paid and deductible in each succeeding year and the limitation applicable to such year under section 404(a)(1)(A), (B), or (C). The provisions of section 404(a)(1)(D) are to be applied before giving effect to the provisions of section 404(a)(7) for any year. The carryover provisions of section 404(a)(1)(D), before effect has been given to section 404(a)(7), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1954:

TAXABLE YEAR ENDING DEC. 31, 1954:	
Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	$40,000
TAXABLE YEAR ENDING DEC. 31, 1955:	
Amount of contributions paid in year	$25,000
Carried over from previous years	40,000
Total deductible subject to limitation	$65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	$15,000
TAXABLE YEAR ENDING DEC. 31, 1956:	
Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	$25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

§ 1.404(a)–8 CONTRIBUTIONS OF AN EMPLOYER UNDER AN EMPLOYEES' ANNUITY PLAN WHICH MEETS THE REQUIREMENTS OF SECTION 401(a); APPLICATION OF SECTION 404(a)(2).—(a) If contributions are paid by an employer under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contribu-

tions are deductible under section 404(a)(2) if the further conditions provided therein are satisfied. For the meaning of "annuity plan" as used here, see § 1.404(a)-3. In order that contributions by the employer may be deducted under section 404(a)(2), all of the following conditions must be satisfied:

(1) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries. See § 1.401-1(a).

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements with respect to discrimination set out in section 401(a)(3), (4), (5), and (6). In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), the succeeding year also must end with or within a taxable year of the plan for which it meets such requirements. See §§ 1.401-3 and 1.401-4. These requirements are considered to be satisfied for the period beginning with the date on which an annuity plan was put into effect and ending with the fifteenth day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. See section 401(b) and § 1.401-5. It should be noted that the period in which a plan may be amended to qualify under section 401(b) ends before the date taxpayers, other than corporations, are required to file income tax returns.

(3) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, or survivorship benefits incidental and directly related to such annuities) under the plan. For the purpose of this condition, "refunds of premiums" means payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where—

(i) All credits are applied regularly, as they are determined, toward the premiums next due under the contracts before any further employer contributions are so applied, and

(ii) Under the arrangement,

(*a*) No refund of premiums may be made during continuance of the plan unless applied as aforesaid, and

(*b*) If refunds of premiums may be made after discontinuance of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service before its discontinuance have been purchased, such refunds will be applied in the taxable year of the employer in

which received, or in the next succeeding taxable year, to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 401(a)(4).

(b) Where the above conditions are satisfied, the amounts of deductions under section 404(a)(2) are governed by the limitations provided in section 404(a)(1). See §§ 1.404(a)–3 to 1.404(a)–7, inclusive.

§ 1.404(a)–9 CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' PROFIT-SHARING OR STOCK BONUS TRUST THAT MEETS THE REQUIREMENTS OF SECTION 401(a); APPLICATION OF SECTION 404(a)(3)(A).—(a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under section 404(a)(3)(A) the contributions must be paid in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. In order that contributions carried over may be deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 404(a)(3)(A), the succeeding year also must end with or within a taxable year of the trust for which it is exempt under section 501(a). This section is also applicable to contributions to a foreign situs profit-sharing or stock bonus trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States.

(b) The amount of deductions under section 404(a)(3)(A) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. For this purpose "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). The limitations under section 404(a)(3)(A) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 404(a)(3)(A), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued during such taxable year to the employees who, in such year, are beneficiaries of the trust funds accumulated under the plan. So long as the contributions do not in any year exceed the primary limitation, this is the only limitation under section 404(a)(3)(A) which has any effect.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years, where contributions in some taxable year are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 404(a)(3)(A) for all prior years.

(e) In any case where the contributions in a taxable year exceed the amount allowable as a deduction for the year under section 404(a)(3)(A), the excess is deductible in succeeding taxable years, in order of time, in which the contributions are less than the primary limitations. However, the total deduction for any such succeeding year cannot exceed the lesser of (1) the primary limitation for such year, or (2) the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

(f) In case deductions are allowable under section 404(a)(1) or (2), as well as under section 404(a)(3)(A), the limitations under section 404(a)(1) and (3)(A) are determined and applied without giving effect to the provisions of section 404(a)(7), but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

(g) The provisions of section 404(a)(3)(A) before giving effect to section 404(a)(7), may be illustrated as follows:

Illustration of provisions of section 404(a)(3)(A) for a plan put into effect in the taxable (calendar) year 1954, before giving effect to section 404(a)(7) (all figures represent thousands of dollars)

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
1. Amount of contributions:							
(i) In taxable year	$65	$10	$15	$100	$70	$40	$30
(ii) Carried over from prior taxable years	0	8	0	0	4	5	3
2. Primary limitation applicable to year:							
15 percent of covered compensation in year [1]	57	54	51	48	45	42	39
3. Secondary limitation applicable to year:							
(i) Twice primary limitation				96	90	84	
(ii) (a) Aggregate primary limitations (see item 2)				$210	$255	$297	
(b) Aggregate prior deductions (see item 4 (iii))				90	186	255	
(c) Excess of (a) over (b)				$120	$69	$42	
(iii) Lesser of (i) or (ii)				96	69	42	
4. Amount deductible for year on account of:							
(i) Contributions in year	$57	$10	$15	$96	$69	$40	$30
(ii) Contributions carried over	0	8	0	0	0	2	3
(iii) Total	$57	$18	$15	$96	$69	$42	$33
5. Excess contributions carried over to succeeding years	8	0	0	4	5	3	0

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

§ 1.404(a)–9(d)

§ 1.404(a)–10 PROFIT-SHARING PLAN OF AN AFFILIATED GROUP; APPLICATION OF SECTION 404(a)(3)(B).—(a) Section 404(a)(3)(B) allows a corporation a deduction to the extent provided in paragraphs (b) and (c) of this section for a contribution which it makes for another corporation to a profit-sharing plan or a stock bonus plan under which contributions are determined by reference to profits, provided the following tests are met:

(1) The corporation for which the contribution is made and the contributing corporation are members of an affiliated group of corporations as defined in section 1504, relating to the filing of consolidated returns, and both such corporations participate in the plan. However, it is immaterial whether all the members of such group participate in the plan.

(2) The corporation for which the contribution is made is required under the plan to make the contribution, but such corporation is prevented from making such contribution because it has neither current nor accumulated earnings or profits, or because its current and accumulated earnings or profits are insufficient to make the required contribution. To the extent that such a corporation has any current or accumulated earnings or profits, it is not considered to be prevented from making its required contribution to the plan.

(3) The contribution is made out of the current or accumulated earnings or profits of the contributing corporation.

(b) The amount that is deductible under section 404(a)(3)(B) is determined by applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 as if the contribution were made by the corporation for which it is made. For example, the primary limitation described in paragraph (c) of § 1.404(a)–9 is determined by reference to the compensation otherwise paid or accrued to the employees of the corporation for which the contribution is made, and the secondary limitation described in paragraph (d) of § 1.404(a)–9 and the contribution carryover described in paragraph (e) of § 1.404(a)–9 are determined by reference to the prior contributions and deductions of such corporation. The contributing corporation may deduct the amount so determined subject to the limitations contained in paragraph (c) of this section. The contributing corporation shall not treat such amount as a contribution made by it in applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 either for the taxable year for which the contribution is made or for succeeding taxable years. The corporation for which the contribution is made shall treat the contribution as having been made by it in applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 for succeeding taxable years.

(c) The allowance of the deduction under section 404(a)(3)(B) does not depend upon whether the affiliated group does or does not file a consolidated return. If a consolidated return is filed, it is immaterial which of the participating corporations makes the contribution and takes the deduction or how the contribution or the deduction is allocated among them. However, if a consolidated return is not filed, the contribution which is deductible under section 404(a)(3)(B) by each contributing corporation shall be limited to that portion of

416926°—57——17

its total current and accumulated earnings or profits (adjusted for its contribution deductible without regard to section 404(a)(3)(B)) which the prevented contribution bears to the total current and accumulated earnings or profits of all the participating members of the group having such earnings or profits (adjusted for all contributions deductible without regard to section 404(a)(3)(B)). For the purpose of this section, current earnings or profits shall be computed as of the close of the taxable year without diminution by reason of any dividends during the taxable year, and accumulated earnings or profits shall be computed as of the beginning of the taxable year.

(d) The application of section 404(a)(3)(B) may be illustrated by the following example in which the affiliated group does not file a consolidated return:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A	($10, 000)	($140, 000)	($150, 000)	$200, 000	1/5	$6, 000	0			
B	(5, 000)	105, 000	100, 000	300, 000	3/10	9, 000	$9, 000	$91, 000	6/326 × 91, 000	$1, 674. 85
C	75, 000	175, 000	250, 000	500, 000	1/2	15, 000	15, 000	235, 000	6/326 × 235, 000	4, 325. 15
Totals	$60, 000	$140, 000	$200, 000	$1, 000, 000		$30, 000	$24, 000	$326, 000		$6, 000. 00

COLUMN: (1) Member.
(2) Earnings and profits of the taxable year.
(3) Accumulated earnings and profits at beginning of taxable year.
(4) Total current and accumulated earnings and profits (column 2 plus column 3).
(5) Compensation of participating employees.
(6) Contribution formula: 50% of consolidated earnings and profits, allocated among participating members in proportion of covered payroll of each to covered payroll of consolidated group.
(7) Individual contribution had it not been prevented.
(8) Individual contribution made by each employer for its own employees.
(9) Balance of accumulated earnings and profits (column 4 minus column 8).
(10) Proportion of make-up contribution.
(11) Make-up contribution.

§ 1.404(a)–11 TRUSTS CREATED OR ORGANIZED OUTSIDE THE UNITED STATES; APPLICATION OF SECTION 404(a)(4).—In order that a trust may constitute a qualified trust under section 401(a) and be exempt under section 501(a), it must be created or organized in the United States and maintained at all times as a domestic trust. See paragraph (a) of § 1.401–1. Paragraph (4) of section 404(a) provides, however, that an employer which is a resident, a corporation, or other entity of the United States, making contributions to a foreign stock bonus, pension, or profit-sharing trust, shall be allowed deductions for such contributions, under the applicable conditions and within the prescribed limits of section 404(a), if such foreign trust would qualify for exemption under section 501(a) except for the fact that it is a trust created, organized, or maintained outside the United States. Moreover, if a nonresident alien individual, foreign corporation, or other entity is engaged in trade or business within the United States and makes contributions to a foreign stock bonus, pension, or profit-sharing trust, which would qualify under section 401(a) and be exempt under section 501(a) except that it is created, organized, or maintained outside the United States, such contributions are de-

ductible subject to the conditions and limitations of section 404(a) and to the extent allowed by section 873 or 882(c).

§ 1.404(a)–12 CONTRIBUTIONS OF AN EMPLOYER UNDER A PLAN THAT DOES NOT MEET THE REQUIREMENTS OF SECTION 401(a); APPLICATION OF SECTION 404(a)(5).—Section 404(a)(5) covers all cases for which deductions are allowable under section 404(a) but not allowable under paragraph (1), (2), (3), (4), or (7) of such section. No deduction is allowable under section 404(a)(5) for any contribution paid or accrued by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under section 404(a). See § 1.404(a)–1. If payments are made under such a plan and the amounts are not deductible under the other paragraphs of section 404(a), they are deductible under paragraph (5) of such subsection to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. If unfunded pensions are paid directly to former employees, their rights to such payments are nonforfeitable, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case when they are not deductible under the other paragraphs of section 404(a). As to what constitutes nonforfeitable rights of an employee in other cases, see § 1.402(b)–1. If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

§ 1.404(a)–13 CONTRIBUTIONS OF AN EMPLOYER WHERE DEDUCTIONS ARE ALLOWABLE UNDER SECTION 404(a)(1) OR (2) AND ALSO UNDER SECTION 404(a)(3); APPLICATION OF SECTION 404(a)(7).—(a) Where deductions are allowable under section 404(a)(1) or (2) on account of contributions under a pension or annuity plan and deductions are also allowable under section 404(a)(3) for the same taxable year, on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 404(a)(7) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 404(a)(1) or (2) is also a beneficiary under the trusts for which deductions are allowable under section 404(a)(3). The provisions of section 404(a)(7) apply only to deductions for overlapping trusts or plans, i. e., for all trusts or plans for which deductions are allowable under section 404(a)(1), (2), or (3) except (1) any trust or plan for which deductions are allowable under section 404(a)(1) or (2) and which does not cover any employee who is also

covered under a trust for which deductions are allowable under section 404(a)(3), and (2) any trust for which deductions are allowable under section 404(a)(3) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 404(a)(1) or (2). The limitations under section 404(a)(7) for any taxable year are based on the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under the overlapping trusts or plans in the year. For this purpose "compensation, otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). The employees who are beneficiaries under overlapping trusts or plans in a year include all the employees who, in the year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans.

(b) Under section 404(a)(7), any excess of the total amount otherwise deductible for the taxable year under section 404(a)(1), (2), or (3) as contributions to overlapping trusts or plans over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans, is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deduction for contributions to such trusts or plans for a succeeding taxable year is equal to the lesser of—

(1) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(2) The sum of (i) the smaller of (*a*) 25 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or (*b*) the total of the amounts otherwise deductible under section 404(a)(1), (2), or (3) for the year for such trusts or plans and (ii) any carryover to the year from prior years under section 404(a)(7), i. e., any excess otherwise deductible under section 404(a)(1), (2), or (3), but not deducted for a prior taxable year because of the limitations under section 404(a)(7).

(c) The limitations under section 404(a)(7) are determined and applied after all the limitations, deductions otherwise allowable, and carryovers under section 404(a)(1), (2), and (3) have been determined and applied, and, in particular, after effect has been given to the carryover provision in section 404(a)(1)(D) and in the second and third sentences of section 404(a)(3)(A). Where the limitations under section 404(a)(7) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carryover which is distinct from, and additional to, any excess contributions carried over and deductible in succeeding years under the provisions in section 404(a)(1)(D) or in the third sentence of section 404(a)(3)(A). The application of the provisions of section 404(a)(7) and the treatment of carryovers for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1954 and covering the same employees may be illustrated as follows:

Illustration of application of provisions of section 404(a)(7) and of treatment of carryovers for overlapping pension and profit-sharing trusts put into effect in 1954 and covering the same employees (all figures represent thousands of dollars)

	Taxable (calendar) years			
	1954	1955	1956	1957
BEFORE GIVING EFFECT TO SECTION 404(a)(7)				
Pension trust contributions and limitations, deductions, and carryovers under section 404(a)(1):				
1. Contributions paid in year	$215	$85	$140	$60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	$215	$90	$140	$80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	$5	0	$20	0
Profit-sharing trust contributions and limitations, deductions, and carryovers under section 404(a)(3):				
7. Contributions paid in year	$200	$125	$105	$65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for years subject to limitation	$200	$160	$115	$65
10. Limitation applicable to year	165	150	135	[1] 110
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	$35	$10	0	0
APPLICATION OF SECTION 404(a)(7)				
Totals for pension and profit-sharing trust:				
13. Amount deductible for year under section 404(a)(7):				
(1) 30 percent of compensation covered in year [2]	[3]	$300	$270	$180
(2) (i) (a) 25 percent of compensation covered in year [2]	275	250	225	150
(b) Total amount otherwise deductible for year: item 5 plus item 11	375	240	235	145
(c) Smaller of (a) or (b)	$275	$240	$225	$145
(ii) Carryover from prior years under section 404(a)(7)	0	100	40	10
(iii) Sum of (i) (c) and (ii)	$275	$340	$265	$155
(3) Amount deductible: Lesser of (1) or (2) (iii)	$275	$300	$265	$155
14. Carryover to succeeding years under section 404(a)(7): item 13(2)(ii) plus item 13(2)(i)(b) minus item 13(3)	$100	$40	$10	0

[1] Includes carryover of 20 from 1956.
[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.
[3] 30 percent limitation not applicable to first year of plan.

§ 1.404(b) STATUTORY PROVISIONS; DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN; METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.

SEC. 404. DEDUCTIONS FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN. * * *

(b) METHOD OF CONTRIBUTIONS, ETC., HAVING THE EFFECT OF A PLAN.—If there is no plan but a method of employer contributions or compensation has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, subsection (a) shall apply as if there were such a plan.

§ 1.404(b)–1 METHOD OF CONTRIBUTION, ETC., HAVING THE EFFECT OF A PLAN; EFFECT OF SECTION 404(b).—Section 404(a) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-

sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to a retired employee or employees or to their beneficiaries in such amounts as may be determined from time to time by the board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee or his beneficiaries, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 404(a). If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

§ 1.404(c) STATUTORY PROVISIONS; DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN; CERTAIN NEGOTIATED PLANS.

SEC. 404. DEDUCTIONS FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN. * * *

(c) CERTAIN NEGOTIATED PLANS.—If contributions are paid by an employer—

(1) under a plan under which such contributions are held in trust for the purpose of paying (either from principal or income or both) for the benefit of employees and their families and dependents at least medical or hospital care, and pensions on retirement or death of employees; and

(2) such plan was established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged,

such contributions shall not be deductible under this section nor be made nondeductible by this section, but the deductibility thereof shall be governed solely by section 162 (relating to trade or business expenses). This subsection shall have no application with respect to amounts contributed to a trust on or after any date on which such trust is qualified for exemption from tax under section 501(a).

§ 1.404(c)–1 CERTAIN NEGOTIATED PLANS; EFFECT OF SECTION 404 (c).—(a) Section 404(a) does not apply to deductions for contributions paid by an employer under a negotiated plan which meets the following conditions:

(1) The contributions under the plan are held in trust for the purpose of paying, either from principal or income or both, for the benefit of employees and their families, at least medical or hospital care, and pensions on retirement or death of employees; and

(2) Such plan was established before January 1, 1954, as a result

of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged.

If these conditions are met, such contributions shall be deductible under section 162, to the extent that they constitute ordinary and necessary business expenses.

(b) The term "as a result of an agreement" is intended primarily to cover a trust established under the terms of an agreement referred to in paragraph (a) (2). It will also include a trust established under a plan of an employer, or group of employers, who are in competition with the employers whose facilities were seized by reason of producing the same commodity, and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. Thus, for example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established about the same time in the anthracite coal industry would be covered by this provision.

(c) If any such trust becomes qualified for exemption under section 501(a), the deductibility of contributions by an employer to such trust on or after the date of such qualification would no longer be governed by section 404(c), even though the trust may later lose its exemption under section 501(a).

§ 1.404(d) Statutory Provisions; Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under a Deferred-Payment Plan; Carryover of Unused Deductions.

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN. * * *

(d) Carryover of Unused Deductions.—The amount of any unused deductions or contributions in excess of the deductible amounts for taxable years to which this part does not apply which under section 23(p) of the Internal Revenue Code of 1939 would be allowable as deductions in later years had such section 23(p) remained in effect, shall be allowable as deductions in taxable years to which this part applies as if such section 23(p) were continued in effect for such years. However, the deduction under the preceding sentence shall not exceed an amount which, when added to the deduction allowable under subsection (a) for contributions made in taxable years to which this part applies, is not greater than the amount which would be deductible under subsection (a) if the contributions which give rise to the deduction under the preceding sentence were made in a taxable year to which this part applies.

§ 1.404(d)–1 Carryover of Unused Deductions; Effect of Section 404(d).—Contributions for taxable years which began before January 1, 1954, (or ended before August 17, 1954, regardless of when they began) in excess of the deductible limits of section 23(p) of the Internal Revenue Code of 1939 which would have been available as carryovers and deductible in succeeding taxable years, in order of time, had such section 23(p) remained in effect, are allowable as deductions for taxable years beginning after December 31, 1953, and ending after August 16, 1954, to the same extent that such deductions would have been allowable had such section 23(p) remained in effect. This

provision, however, does not increase a deduction for a taxable year beyond the applicable limits of such section 404(a) had the carryover constituted part of the contribution for such year. Thus, for example, if a pension plan had been put into effect as of January 1, 1953, when the past service liability was $1,000,000, and the employer contributed $500,000 in 1953, only $100,000 would be deductible in 1953 under section 23(p)(1)(A)(iii) of the 1939 Code, and $400,000 was available as a carryover to 1954 under section 23(p)(1)(A)(iv). If the employer made a contribution of the remaining $500,000 in 1954, it would not result in allowable deductions of $200,000 for past service funding in that year (i. e., $100,000 under section 404(a) and another $100,000 under section 404(d)). The total allowable deduction for such funding would be only $100,000 for 1954 (10 percent of the initial past service liability of $1,000,000), and the carryover to 1955 would be $800,000. Also, unused deduction carryovers which arose under the second sentence of section 23(p)(1)(C) of the 1939 Code are continued for years beginning after December 31, 1953, as though arising under the second sentence of section 404(a)(3)(A).

Banking Institutions

RULES OF GENERAL APPLICATION TO BANKING INSTITUTIONS

§ 1.581 Statutory Provisions; Definition of Bank.

SEC. 581. DEFINITION OF BANK.

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U. S. C. 248(k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

§ 1.581–1 Tax on Banks.—A bank, as defined in section 581, is subject to the tax on corporations imposed by section 11.

§ 1.581–2 Mutual Savings Banks, Building and Loan Associations, and Cooperative Banks.—(a) Mutual savings banks, building and loan associations, and cooperative banks not having capital stock represented by shares are subject to tax as in the case of other corporations. For special rules governing the taxation of a mutual savings bank conducting a life insurance business, see section 594 and § 1.594–1.

(b) While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank not having capital stock represented by shares, there are certain exceptions and special rules governing the computation in the case of such institutions. See section 593 and § 1.593–1 for special rules concerning additions to reserves for bad debts. See section 591 and § 1.591–1, relating to dividends paid by banking corporations, for special rules concerning deductions for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts as dividends. See

also section 592 and § 1.592–1, relating to deductions for repayment of certain loans.

(c) For the purpose of computing the net operating loss deduction provided in section 172, any taxable year for which a mutual savings bank, building and loan association, or a cooperative bank not having capital stock represented by shares was exempt from tax shall be disregarded. Thus, no net operating loss carryover shall be allowed from a taxable year beginning before January 1, 1952, and, in the case of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning before January 1, 1952.

§ 1.582 STATUTORY PROVISIONS; BAD DEBT AND LOSS DEDUCTION WITH RESPECT TO SECURITIES HELD BY BANKS.

SEC. 582. BAD DEBT AND LOSS DEDUCTION WITH RESPECT TO SECURITIES HELD BY BANKS.

(a) SECURITIES.—Notwithstanding sections 165(g)(1) and 166(e), subsections (a), (b), and (c) of section 166 (relating to allowance of deduction for bad debts) shall apply in the case of a bank to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

(b) WORTHLESS STOCK IN AFFILIATED BANK.—For purposes of section 165(g)(1), where the taxpayer is a bank and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) BOND, ETC., LOSSES OF BANKS.—For purposes of this subtitle, in the case of a bank, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

§ 1.582–1 BAD DEBT AND LOSS DEDUCTION WITH RESPECT TO SECURITIES HELD BY BANKS.—(a) A bank, as defined in section 581, is allowed a deduction for bad debts to the extent and in the manner provided by subsections (a), (b), and (c) of section 166 with respect to a debt which has become worthless in whole or in part and which is evidenced by a security (a bond, debenture, note, certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money) issued by any corporation (including governments and their political subdivisions), with interest coupons or in registered form.

(b) For purposes of section 165(g)(1), relating to the deduction for losses involving worthless securities, if the taxpayer is a bank (as defined in section 581) and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) With respect to the taxation under subtitle A of a bank (as defined in section 581), if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

§ 1.583 Statutory Provisions; Deductions of Dividends Paid on Certain Preferred Stock.

SEC. 583. DEDUCTIONS OF DIVIDENDS PAID ON CERTAIN PREFERRED STOCK.

In computing the taxable income of any national banking association, or of any bank or trust company organized under the laws of any State, Territory, possession of the United States, or the Canal Zone, or of any other banking corporation engaged in the business of industrial banking and under the supervision of a State banking department or of the Comptroller of the Currency, or of any incorporated domestic insurance company, there shall be allowed as a deduction from gross income, in addition to deductions otherwise provided for in this subtitle, any dividend (not including any distribution in liquidation) paid, within the taxable year, to the United States or to any instrumentality thereof exempt from Federal income taxes, on the preferred stock of the corporation owned by the United States or such instrumentality. The amount allowable as a deduction under this section shall reduce the deduction for dividends paid otherwise computed under section 561.

§ 1.584 Statutory Provisions; Common Trust Funds.

SEC. 584. COMMON TRUST FUNDS.

(a) Definitions.—For purposes of this subtitle, the term "common trust fund" means a fund maintained by a bank—

(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and

(2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks.

(b) Taxation of Common Trust Funds.—A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation.

(c) Income of Participants in Fund.—

(1) Inclusions in taxable income.—Each participant in the common trust fund in computing its taxable income shall include, whether or not distributed and whether or not distributable—

(A) as part of its gains and losses from sales or exchanges of capital assets held for not more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for not more than 6 months;

(B) as part of its gains and losses from sales or exchanges of capital assets held for more than 6 months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than 6 months;

(C) its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in subsection (d).

(2) Dividends and partially tax exempt interest.—The proportionate share of each participant in the amount of dividends to which section 34 or section 116 applies, and in the amount of partially tax exempt interest on obligations described in section 35 or section 242, received by the common trust fund shall be considered for purposes of such sections as having been received by such participant. If the common trust fund elects under section 171 (relating to amortizable bond premium) to amortize the premium on such obligations, for purposes of the preceding sentence the proportionate share of the participant of such interest received by the common trust fund shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share.

(d) Computation of Common Trust Fund Income.—The taxable income of a common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(1) there shall be segregated the gains and losses from sales or exchanges of capital assets;

(2) after excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed—

(A) an ordinary taxable income which shall consist of the excess of the gross income over deductions; or

(B) an ordinary net loss which shall consist of the excess of the deductions over the gross income;

(3) the deduction provided by section 170 (relating to charitable, etc., contributions and gifts) shall not be allowed; and

(4) the standard deduction provided in section 141 shall not be allowed.

(e) Admission and Withdrawal.—No gain or loss shall be realized by the common trust fund by the admission or withdrawal of a participant. The withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

(f) Different Taxable Years of Common Trust Fund and Participant.—If the taxable year of the common trust fund is different from that of a participant, the inclusions with respect to the taxable income of the common trust fund, in computing the taxable income of the participant for its taxable year, shall be based upon the taxable income of the common trust fund for any taxable year of the common trust fund ending within or with the taxable year of the participant.

(g) Net Operating Loss Deduction.—The benefit of the deduction for net operating losses provided by section 172 shall not be allowed to a common trust fund, but shall be allowed to the participants in the common trust fund under regulations prescribed by the Secretary or his delegate.

§ 1.584–1 Common Trust Funds.—(a) *Method of taxation.*—A common trust fund maintained by a bank is not subject to taxation under this chapter and is not considered a corporation. Its participants are taxed on their proportionate share of income from the common trust fund. Except as otherwise provided in §§ 1.584–1 to 1.584–6, inclusive, the term "participant" refers to any trust or estate, the moneys of which have been contributed to the common trust fund.

(b) *Conditions for qualification.*—Under section 584, two conditions must be satisfied by a fund maintained by a bank (as defined in section 581) before such fund may be designated as a "common trust fund." These conditions are that such fund must be maintained by such a bank—

(1) Exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank, whether acting alone or in conjunction with one or more co-fiduciaries, but solely in its capacity: (i) As a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court, (ii) as an executor of the will of, or as an administrator of the estate of, a deceased person, or (iii) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompetent individual, or of an absent individual; and

(2) In conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks, whether or not the bank maintaining such fund is a national bank or a member of the Federal Reserve System.

§ 1.584–2 Income of Participants in Common Trust Fund.—(a) Each participant in a common trust fund is required to include in

computing its taxable income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable—

(1) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for not more than six months, computed as provided in § 1.584–3, as part of its gains and losses from sales or exchanges of capital assets held for not more than six months;

(2) Its proportionate share of the gains and losses from sales or exchanges of capital assets held for more than six months, computed as provided in § 1.584–3, as part of its gains and losses from sales or exchanges of capital assets held for more than six months; and

(3) Its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in § 1.584–3.

(b)(1) Each participant's proportionate share in the amount of dividends to which section 34 or section 116 applies received by the common trust fund shall be deemed to have been received by such participant as such dividends.

(2) Each participant's proportionate share in the amount of partially tax exempt interest described in section 35 or section 242 received by the common trust fund shall be deemed to have been received by such participant as such interest. If the common trust fund elects under section 171 (relating to amortizable bond premium) to amortize the premium on such obligations, for purposes of the preceding sentence the proportionate share of each participant of such interest received by the fund shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share. See section 171 and the regulations thereunder.

(3) Any tax withheld at the source from income of the fund shall be deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c)(1) The proportionate share of each participant in gains and losses from sales or exchanges of capital assets held for not more than six months, gains and losses from sales or exchanges of capital assets held for more than six months, ordinary taxable income or ordinary net loss, dividends received, partially exempt interest, and tax withheld at the source shall be determined under the method of accounting adopted by the bank in accordance with the written plan under which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

(2) The items of income and deductions are, therefore, to be allocated to the periods between valuation dates within the taxable year established by such plan in which they were realized or sustained, and the ordinary taxable income or ordinary net loss, gains and losses from sales or exchanges of capital assets held for not more than six months, and gains and losses from sales or exchanges of capital assets held for more than six months computed for each such period. The pro-

portionate shares of the participants in such items are then to be determined.

(3) The provisions of subparagraph (2) of this paragraph may be illustrated by the following example:

Example. (i) The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trust A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary taxable income, the short-term capital gain, and the long-term capital loss for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary taxable income	$200	$300	$200	$400	$1, 100
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

(ii) The participants' shares of ordinary taxable income are as follows:

Participants' shares of ordinary taxable income

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75			125
D	50				50
E		75			75
F			50	100	150
G			50	100	150
Total	$200	$300	$200	$400	$1, 100

(iii) The participants' shares of the short-term capital gain are as follows:

Participants' shares of short-term capital gain

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25			75
D	50				50
E		25			25
F			50	25	75
G			50	25	75
Total	$200	$100	$200	$100	$600

(iv) The participants' shares of the long-term capital loss are as follows:

Participants' shares of long-term capital loss

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50	--------	--------	75
D	25	--------	--------	--------	25
E	--------	50	--------	--------	50
F	--------	--------	25	50	75
G	--------	--------	25	50	75
Total	$100	$200	$100	$200	$600

(4) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(d) The provisions of subparts A, B, C, D, and E of part I of subchapter J are applicable in determining the extent to which each participant's proportionate share of the income of the common trust fund is taxable to the participant, or to the beneficiaries or the grantor of the participant.

§ 1.584–3 COMPUTATION OF COMMON TRUST FUND INCOME.—The taxable income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) No deduction shall be allowed under section 170 (relating to charitable, etc., contributions and gifts);

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carryover provided by section 1212;

(c) The ordinary taxable income (the excess of the gross income over deductions) or the ordinary net loss (the excess of the deductions over the gross income) shall be computed after excluding all items of gain and loss from sales or exchanges of capital assets; and

(d) The standard deduction provided in section 141 shall not be allowed.

§ 1.584–4 ADMISSION AND WITHDRAWAL OF PARTICIPANTS IN THE COMMON TRUST FUND.—(a) *Gain or loss.*—The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 1202 are unaffected by such an admission or withdrawal. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or

portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of subdivision (c)(7) of section 17 of Regulation F of the Board of Governors of the Federal Reserve System, as amended, for the benefit of all the then participants in the common trust fund. Such segregated investment shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated.

(b) *Basis for gain or loss upon withdrawal.*—The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the adjusted basis of the participating interest or portion thereof withdrawn plus the additions prescribed in paragraph (c) of this section and minus the reductions prescribed in paragraph (d) of this section. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the sum of any money plus the fair market value of any property (other than money) contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of subdivisions (c)(7) of section 17 of Regulation F of the Board of Governors of the Federal Reserve System, as amended. For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust, shall be deemed to be the participant, to the extent that the income of the trust is taxable to the grantor under subpart E of part I of subchapter J.

(c) *Additions to basis.*—As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items (to the extent that they were properly allocated to the participant for a taxable year of the common trust fund and were not distributed to the participant prior to withdrawal):

(1) Wholly exempt income of the common trust fund for any taxable year,

(2) Net income of the common trust fund for the taxable years beginning after December 31, 1935, and prior to January 1, 1938,

(3) Net short-term capital gain of the common trust fund for each taxable year beginning after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund upon sales or exchanges of capital assets held (i) for more than 18 months for taxable years beginning after December 31, 1937, and before January 1, 1942, and (ii) for more than 6 months for taxable years beginning after December 31, 1941, and

(5) Ordinary net or taxable income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) *Reductions in basis.*—As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion thereof withdrawn:

(1) The amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and before January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

§ 1.584–5 Returns of Banks With Respect to Common Trust Funds.—For rules applicable to filing returns of common trust funds, see section 6032 and the regulations thereunder.

§ 1.584–6 Net Operating Loss Deduction.—The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction, a participant in a common trust fund shall take into account its pro rata share of items of income, gain, loss, deduction, or credit of the common trust fund. The character of any such item shall be determined as if the participant had realized such item directly from the source from which realized by the common trust fund, or incurred such item in the same manner as incurred by the common trust fund.

MUTUAL SAVINGS BANKS, ETC.

§ 1.591 Statutory Provisions; Deduction for Dividends Paid on Deposits.

SEC. 591. DEDUCTION FOR DIVIDENDS PAID ON DEPOSITS.

In the case of mutual savings banks, cooperative banks, and domestic building and loan associations, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

§ 1.591–1 Deduction for Dividends Paid on Deposits.—(a) *In general.*—(1) A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may deduct from gross income amounts

which during the taxable year are paid to or credited to the accounts of depositors or holders of accounts, as dividends on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(2) The deduction provided in section 591 is applicable to the taxable year in which amounts credited as dividends become withdrawable by the depositor or holder of account subject only to customary notice of intention to withdraw. Thus, amounts credited as dividends as of the last day of the taxable year which are not withdrawable by depositors or holders of accounts until the following business day are deductible under section 591 in the year subsequent to the taxable year in which they were credited. A deduction under this section will not be denied by reason of the fact that the amounts credited as dividends, otherwise deductible under section 591, are subject to the terms of a pledge agreement between the institution and the depositor or holder of account. In the case of a building and loan association having nonwithdrawable capital stock represented by shares, no deduction is allowable under this section for amounts paid or credited as dividends on such shares.

(b) *Serial associations, bonus plans, etc.*—If a building and loan association operates in whole or in part as a serial association, maintains a bonus plan, or issues shares subject to fines, penalties, forfeitures, or other withdrawable fees, it may deduct under section 591 the total amount credited as dividends upon such shares, credited to a bonus account for such shares, or allocated to a series of shares for the taxable year, notwithstanding that as a customary condition of withdrawal—

(1) Amounts invested in, and earnings credited to, series shares must be withdrawn in multiples of even shares, or

(2) Such association has the right, pursuant to by-law, contract, or otherwise, to retain or recover a portion of the total amount invested in, or credited as earnings upon, such shares, such bonus account, or series of shares, as a fine, penalty, forfeiture, or other withdrawal fee.

In any taxable year in which the right referred to in subparagraph (2) of this paragraph is exercised, there is includible in the gross income of such association for such taxable year amounts retained or recovered by the association pursuant to the exercise of such right.

§ 1.592 STATUTORY PROVISIONS; DEDUCTION FOR REPAYMENT OF CERTAIN LOANS.

SEC. 592. DEDUCTION FOR REPAYMENT OF CERTAIN LOANS.

In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, there shall be allowed as deductions in computing taxable income amounts paid by the taxpayer during the taxable year in repayment of loans made before September 1, 1951, by (1) the United States or any agency or instrumentality thereof which is wholly owned by the United States, or (2) any mutual fund established under the authority of the laws of any State.

416926°—57——18

§ 1.592-1 REPAYMENT OF CERTAIN LOANS BY MUTUAL SAVINGS BANKS, BUILDING AND LOAN ASSOCIATIONS, AND COOPERATIVE BANKS.— There is deductible, under section 592, from the gross income of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by such institutions during the taxable year in repayment of loans made before September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States, or by any mutual fund established under the authority of the laws of any State. For example, amounts paid by such institution in repayment of loans made by the Reconstruction Finance Corporation before September 1, 1951, are deductible under this section. Section 592 is not applicable, however, in the case of amounts paid in repayment of loans made by an agency or instrumentality not wholly owned by the United States.

§ 1.593 STATUTORY PROVISIONS; ADDITIONS TO RESERVE FOR BAD DEBTS.

SEC. 593. ADDITIONS TO RESERVE FOR BAD DEBTS.

In the case of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit, the reasonable addition to a reserve for bad debts under section 166(c) shall be determined with due regard to the amount of the taxpayer's surplus or bad debt reserves existing at the close of December 31, 1951. In the case of a taxpayer described in the preceding sentence, the reasonable addition to a reserve for bad debts for any taxable year shall in no case be less than the amount determined by the taxpayer as the reasonable addition for such year; except that the amount determined by the taxpayer under this sentence shall not be greater than the lesser of—

(1) the amount of its taxable income for the taxable year, computed without regard to this section, or

(2) the amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

§ 1.593-1 ADDITIONS TO RESERVE FOR BAD DEBTS.—(a) *In general.*— A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may, as an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, deduct amounts credited to a reserve for bad debts in the manner and under the circumstances prescribed in this section and § 1.593-2. In the case of such an institution, the selection of either of the alternative methods for treating bad debts may be made by the taxpayer in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, unless permission is granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30

days prior to the close of the taxable year for which the change is to be effective.

(b) *Addition to reserve.*—Except as otherwise provided in § 1.593–2, the reasonable addition to a reserve for bad debts shall be any amount determined by the taxpayer which does not exceed the lesser of—

(1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), or

(2) The amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

(c) *Adjustments to reserve.*—Bad debt losses sustained during the taxable year shall be charged against the bad debt reserve. Recoveries of debts charged against the bad debt reserve during a prior taxable year in which the institution was subject to tax under this chapter or under chapter 1 of the Internal Revenue Code of 1939 shall be credited to the bad debt reserve. The establishment of such reserve and all adjustments made thereto must be reflected on the regular books of account of the institution at the close of the taxable year, or as soon as practicable thereafter. Minimum amounts credited in compliance with Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissive under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by an institution, will be deemed to have been credited to the bad debt reserve.

(d) *Definitions.*—When used in this section and in § 1.593–2—

(1) *Institution.*—The term "institution" means either a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701(a)(19), or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(2) *Surplus, undivided profits, and reserves.*—(i) The phrase "surplus, undivided profits, and reserves" means the amount by which the total assets of an institution exceed the amount of the total liabilities of such an institution.

(ii) For this purpose the term "total assets" means the sum of money, plus the aggregate of the adjusted basis of the property other than money, held by an institution. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes. (See sections 1011 through 1022, and the regulations thereunder. For special rules with respect to adjustments to basis for prior taxable years during which the institution was exempt from tax, see section 1016(a)(3) and the regulations thereunder.) The determination of the total assets of any taxpayer shall conform to the method of accounting employed by such taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits.

(iii) The term "total liabilities" means all liabilities of the taxpayer, which are fixed and determined, absolute and not contingent, and includes those items which constitute liabilities in the sense of debts or obligations. The total deposits or withdrawable accounts, as defined in subparagraph (3) of this paragraph, shall be considered a liability. In the case of a building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. Reserves for contingencies and other reserves, however, which are mere appropriations of surplus, are not liabilities.

(3) *Total deposits or withdrawable accounts.*—The phrase "total deposits or withdrawable accounts" means the aggregate of (i) amounts placed with an institution for deposit or investment and (ii) earnings outstanding on the books of account of the institution at the close of the taxable year which have been credited as dividends upon such accounts prior to the close of the taxable year, except that such term, in the case of a building and loan association, does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

Example (1). (i) Institution X, which keeps its books on the basis of the calendar year, has surplus, reserves, and undivided profits of $800,000 as of January 1, 1955, and total deposits or withdrawable accounts of $10,000,000 as of December 31, 1955. During 1955 the institution credits $30,000, as required by a Federal agency, to a Federal insurance reserve for the sole purpose of absorbing losses. Likewise, it credits $25,000, as permitted by State statute, to another reserve fund for the purpose of absorbing losses. In 1955 Institution X charges $5,000 against its bad debt reserve for losses sustained during the taxable year.

(ii) The taxable income of Institution X for the taxable year 1955, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $200,000.

(iii) Upon the basis of the facts as stated in subdivision (i) above, the amount by which 12 percent of the total deposits or withdrawable accounts of Institution X at the close of taxable year 1955 exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $400,000 (12% of $10,000,000, minus $800,000).

(iv) Institution X, therefore, may deduct, for the taxable year 1955, as an addition to a reserve for bad debts, any amount it may determine that does not exceed the lesser of the amounts determined in subdivision (ii) or (iii) above. That amount is $200,000 (as determined in subdivision (ii) above). Since under paragraph (c) of this section, the $30,000 credited to the reserve as required by the Federal agency and the $25,000 credited to the reserve as permitted by the State statute are regarded as amounts credited to a reserve for bad debts account, Institution X can credit an additional $145,000

($200,000 minus $55,000) to a general reserve for bad debts account at any time during the taxable year.

(v) The loss of $5,000 charged to the bad debt reserve during the taxable year does not affect the amount of the addition to the bad debt reserve provided for in paragraph (b) of this section. It is of significance only in determining the surplus, undivided profits, and reserves of Institution X as of January 1, 1956.

Example (2). The taxable income of Institution Y for the taxable year 1955, computed without regard to the deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is determined to be $250,000. The amount by which 12 percent of the total deposits or withdrawable accounts of Institution Y at the close of the taxable year exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $500,000. Institution Y credits $250,000 to its bad debt reserve in 1955. In 1957, it is determined that the correct taxable income of Institution Y for 1955, computed without regard to any deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $275,000 and not $250,000. Assuming that Institution Y credits the additional $25,000 to its bad debt reserve, $275,000 is allowable as a deduction from gross income for such institution for the taxable year 1955.

§ 1.593–2 ADDITIONS TO RESERVE FOR BAD DEBTS WHERE SURPLUS, RESERVES, AND UNDIVIDED PROFITS EQUAL OR EXCEED 12 PERCENT OF DEPOSITS OR WITHDRAWABLE ACCOUNTS.—Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year is equal to or less than the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year, a reasonable addition to the reserve for bad debts as determined under the general provisions of section 166(c) may be allowable as a deduction from gross income. In making such determination, there shall be taken into account (a) surplus or bad debt reserves existing at the close of December 31, 1951 (i. e., the amount of surplus, undivided profits, and reserves accumulated prior to January 1, 1952, and in existence at the close of December 31, 1951), and (b) changes in the surplus, undivided profits, and reserves of the institution from December 31, 1951, until the beginning of the taxable year. A deduction for an addition to the reserve for bad debts pursuant to this section will be authorized only in those cases where the institution proves to the satisfaction of the Commissioner that the bad debt experience of the institution warrants an addition to the reserve for bad debts in excess of that provided in paragraph (b) of § 1.593–1. For definitions, see paragraph (d) of § 1.593–1.

§ 1.594 STATUTORY PROVISIONS; ALTERNATIVE TAX FOR MUTUAL SAVINGS BANKS CONDUCTING LIFE INSURANCE BUSINESS.

SEC. 594. ALTERNATIVE TAX FOR MUTUAL SAVINGS BANKS CONDUCTING LIFE INSURANCE BUSINESS

(a) ALTERNATIVE TAX.—In the case of a mutual savings bank not having capital stock represented by shares, authorized under State law to engage

in the business of issuing life insurance contracts, and which conducts a life insurance business in a separate department the accounts of which are maintained separately from the other accounts of the mutual savings bank, there shall be imposed in lieu of the taxes imposed by section 11 or section 1201(a), a tax consisting of the sum of the partial taxes determined under paragraphs (1) and (2):

(1) A partial tax computed on the taxable income determined with out regard to any items of gross income or deductions properly allocable to the business of the life insurance department, at the rates and in the manner as if this section had not been enacted; and

(2) a partial tax computed on the income of the life insurance department determined without regard to any items of gross income or deductions not properly allocable to such department, at the rates and in the manner provided in subchapter L (sec. 801 and following) with respect to life insurance companies.

(b) LIMITATIONS OF SECTION.—Subsection (a) shall apply only if the life insurance department would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

[Sec. 594 as amended by sec. 5(3), Life Insurance Company Tax Act for 1955.]

§ 1.594–1 MUTUAL SAVINGS BANKS CONDUCTING LIFE INSURANCE BUSINESS.—(a) *Scope of application.*—Section 594 applies to the case of a mutual savings bank not having capital stock represented by shares which conducts a life insurance business, if—

(1) The conduct of the life insurance business is authorized under State law,

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

(b) *Computation of tax.*—In the case of a mutual savings bank conducting a life insurance business to which section 594 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under section 11 upon the taxable income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department, and

(2) A partial tax computed on the income (or, in the case of taxable years beginning before January 1, 1955, the taxable income (as defined in section 803)) of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department, at the rates and in the manner provided in subchapter L (section 801 and following) with respect to life insurance company.

BANK AFFILIATES

§ 1.601 STATUTORY PROVISIONS; SPECIAL DEDUCTION FOR BANK AFFILIATES.

SEC. 601. SPECIAL DEDUCTION FOR BANK AFFILIATES.

In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933; 12 U. S. C. 221a(c)), there shall be allowed as a deduction, for purposes of section 535(b)(8) (relating to the computation of ac-

cumulated taxable income) and section 545(b)(6) (relating to the computation of undistributed personal holding company income), the amount of the earnings and profits which the Board of Governors of the Federal Reserve System certifies to the Secretary or to his delegate has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other than bank stock in compliance with section 5144 of the Revised Statutes (12 U. S. C. 61). The amount of the deduction under this section for any taxable year shall not exceed the taxable income for such year computed without regard to the special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.). The aggregate of the deductions allowable under this section and the credits allowable under the corresponding provisions of any prior income tax law for all taxable years shall not exceed the amount required to be devoted under such section 5144 to such purposes.

§ 1.601–1 SPECIAL DEDUCTION FOR BANK AFFILIATES.—(a) The special deduction described in section 601 is allowed—

(1) To a holding company affiliate of a bank, as defined in section 2 of the Banking Act of 1933 (12 U. S. C. 221a), which holding company affiliate holds, at the end of the taxable year, a general voting permit granted by the Board of Governors of the Federal Reserve System.

(2) In the amount of the earnings or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes (12 U. S. C. 61), has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock.

(3) Upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year.

No deduction is allowable under section 601 for the amount of readily marketable assets in excess of what is required by section 5144 of the Revised Statutes (12 U. S. C. 61) to be acquired by such affiliate, or in excess of the taxable income for the taxable year computed without regard to the special deductions for corporations provided in sections 241–247, inclusive. Nor may the aggregate of the deductions allowable under section 601 and the credits allowable under the corresponding provisions of any prior income tax law for all taxable years exceed the amount required to be devoted under such section 5144 to the acquisition of readily marketable assets other than bank stock.

(b) Every taxpayer claiming a deduction provided for in section 601 shall attach to its return a supplementary statement setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such

readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see section 5144(b) and (c) of the Revised Statutes (12 U.S.C. 61).

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

§ 1.641–1 SCOPE OF SUBCHAPTER J.—Subchapter J (section 641 through 692) of chapter 1 of the Internal Revenue Code of 1954 deals with the taxation of income of estates and trusts and their beneficiaries, and of income in respect of decedents. Part I of subchapter J contains general rules for taxation of estates and trusts (subpart A) and specific rules relating to trusts which distribute current income only (subpart B), estates and trusts which may accumulate income or which distribute corpus (subpart C), treatment of excess distributions by trusts (subpart D), grantors and other persons treated as substantial owners (subpart E), and miscellaneous provisions relating to limitations on charitable deductions, income of an estate or trust in case of divorce, and taxable years to which the provisions of subchapter J are applicable (subpart F). Part II of subchapter J relates to the treatment of income in respect of decedents. However, the provisions of subchapter J do not apply to employees' trusts subject to subchapters D and F and common trust funds subject to subchapter H.

ESTATES, TRUSTS, AND BENEFICIARIES

§ 1.641–2 SCOPE OF SUBPARTS A, B, C, AND D.—Subparts A, B, C, and D (sections 641 to 668, inclusive) relate to the taxation of estates and trusts and their beneficiaries. These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Internal Revenue Code, as that of the grantor or others treated as its substantial owners. See subpart E (sections 671 to 678, inclusive) of subchapter J and regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. So-called alimony trusts are treated under subparts A, B, C, and D except to the extent otherwise provided in section 71 or section 682. These subparts have no application to beneficiaries of nonexempt employees' trusts. See section 402(b) and the regulations thereunder.

GENERAL RULES FOR TAXATION OF ESTATES AND TRUSTS

§ 1.641(a) STATUTORY PROVISIONS; ESTATES AND TRUSTS; IMPOSITION OF TAX; APPLICATION OF TAX.

SEC. 641. IMPOSITION OF TAX.

(a) APPLICATION OF TAX.—The taxes imposed by this chapter on individuals shall apply to the taxable income of estates or of any kind of property held in trust, including—

(1) income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(3) income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

§ 1.641(a)–1 Imposition of Tax; Application of Tax.—Section 641 prescribes that the taxes imposed upon individuals by chapter 1 apply to the income of estates or of any kind of property held in trust. The rates of tax, the statutory provisions respecting gross income and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trusts.

§ 1.641(a)–2 Gross Income of Estates and Trusts.—The gross income of an estate or trust is determined in the same manner as that of an individual. Thus, the gross income of an estate or trust consists of all items of gross income received during the taxable year, including—

(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(b) Income accumulated or held for future distribution under the terms of the will or trust;

(c) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(d) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(e) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

The several classes of income enumerated in this section do not exclude others which also may come within the general purposes of section 641.

§ 1.641(b) Statutory Provisions; Estates and Trusts; Computation and Payment of Tax.

SEC. 641. IMPOSITION OF TAX. * * *

(b) Computation and Payment.—The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

§ 1.641(b)–1 Computation and Payment of Tax; Deductions and Credits of Estates and Trusts.—Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there are special rules for the computation of certain deductions and for the allocation between the estate or trust and the beneficiaries of certain credits and deductions. See section 642 and the regulations thereunder. In addition, an estate or trust is allowed to deduct, in computing its taxable income, the deductions provided by sections 651 and 661 and regulations thereunder, relating to distributions to beneficiaries.

§ 1.641(b)–2 Filing of Returns and Payment of the Tax.—(a) The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not

such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (31 U. S. C. 192). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. See section 6901. The same considerations apply to trusts.

(b) The estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust. See section 6012(b)(2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.

§ 1.641(b)–3 TERMINATION OF ESTATES AND TRUSTS.—(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(b) Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after

the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(c) During the period between the occurrence of an event which causes a trust to terminate and the time when a trust is considered as terminated under this section, the income and the excess of capital gains over capital losses of the trust are in general considered as amounts required to be distributed for the year in which they are received. For example, a trust instrument provides for the payment of income to A during her life, and upon her death for the payment of the corpus to B. The trust reports on the basis of the calendar year. A dies on November 1, 1955, but no distribution is made to B until January 15, 1956. The income of the trust and the excess of capital gains over capital losses for the entire year 1955, to the extent not paid, credited, or required to be distributed to A or A's estate, are treated under sections 661 and 662 as amounts required to be distributed to B for the year 1955.

(d) If a trust or the administration or settlement of an estate is considered terminated under this section for Federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust.

§ 1.642(a)(1) Statutory Provisions; Estates and Trusts; Special Rules for Credits and Deductions; Partially Tax-Exempt Interest.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS.

(a) Credits Against Tax.—

(1) Partially tax-exempt interest.—An estate or trust shall be allowed the credit against tax for partially tax-exempt interest provided by section 35 only in respect of so much of such interest as is not properly allocable to any beneficiary under section 652 or 662. If the estate or trust elects under section 171 to treat as amortizable the premium on bonds with respect to the interest on which the credit is allowable under section 35, such credit (whether allowable to the estate or trust or to the beneficiary) shall be reduced under section 171(a)(3).

§ 1.642(a)(1)-1 Partially Tax-Exempt Interest.—An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the

beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

§ 1.642(a)(2) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; FOREIGN TAXES.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS.

(a) CREDITS AGAINST TAX. * * *

(2) FOREIGN TAXES.—An estate or trust shall be allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States, to the extent allowed by section 901, only in respect of so much of the taxes described in such section as is not properly allocable under such section to the beneficiaries.

§ 1.642(a)(2)-1 FOREIGN TAXES.—An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901(b)(4). For purposes of section 901(b)(4), the term "beneficiaries" includes charitable beneficiaries.

§ 1.642(a)(3) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; DIVIDENDS.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS.

(a) CREDITS AGAINST TAX. * * *

(3) DIVIDENDS RECEIVED BY INDIVIDUALS.—An estate or trust shall be allowed the credit against tax for dividends received provided by section 34 only in respect of so much of such dividends as is not properly allocable to any beneficiary under section 652 or 662. For purposes of determining the time of receipt of dividends under section 34 and section 116, the amount of dividends properly allocable to a beneficiary under section 652 or 662 shall be deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

§ 1.642(a)(3)-1 DIVIDENDS RECEIVED BY AN ESTATE OR TRUST.—An estate or trust is allowed a credit against tax for dividends received (see section 34) only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. For treatment of the credit in the hands of the beneficiary see § 1.652(b)-1.

§ 1.642(a)(3)-2 TIME OF RECEIPT OF DIVIDENDS BY BENEFICIARY.—In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30,[1] receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652(c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34, and his dividends exclusion under section 116. However, solely for purposes of determining whether dividends deemed received by individuals from trusts or estates qualify under the time limita-

[1 Editorial Note: Should have been 31.]

tions of section 34(a) or section 116(a), section 642(a)(3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 [1] receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34(a) or section 116(a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954.

§ 1.642(a)(3)–3 Cross Reference.—See § 1.683–2(c) for examples relating to the treatment of dividends received by an estate or trust during a fiscal year beginning in 1953 and ending in 1954.

§ 1.642(b) Statutory Provisions; Estates and Trusts; Special Rules for Credits and Deductions; Personal Exemption.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(b) Deduction for Personal Exemption.—An estate shall be allowed a deduction of $600. A trust which, under its governing instrument, is required to distribute all of its income currently shall be allowed a deduction of $300. All other trusts shall be allowed a deduction of $100. The deductions allowed by this subsection shall be in lieu of the deductions allowed under section 151 (relating to deduction for personal exemption).

§ 1.642(b)–1 Deduction for Personal Exemption.—In lieu of the deduction for personal exemptions provided by section 151—

(a) An estate is allowed a deduction of $600,

(b) A trust which, under its governing instrument, is required to distribute currently all of its income for the taxable year is allowed a deduction of $300, and

(c) All other trusts are allowed a deduction of $100.

A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of $300, even though it also distributes amounts other than income in the taxable year and even though it may be required to make distributions which would qualify for the charitable contributions deduction under section 642(c) (and therefore does not qualify as a "simple trust" under sections 651–652). A trust for the payment of an annuity is allowed a deduction of $300 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year. For the meaning of the term "income required to be distributed currently," see § 1.651(a)–2.

§ 1.642(c) Statutory Provisions; Estates and Trusts; Special Rules for Credits and Deductions; Charitable Contributions Deduction.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(c) Deduction for Amounts Paid or Permanently Set Aside for a Charitable Purpose.—In the case of an estate or trust (other than a trust meeting the specifications of subpart (B)) there shall be allowed as a deduction in computing its taxable income (in lieu of the deductions allowed by section

170(a), relating to deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid or permanently set aside for a purpose specified in section 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit. For this purpose, to the extent that such amount consists of gain from the sale or exchange of capital assets held for more than 6 months, proper adjustments of the deduction otherwise allowable under this subsection shall be made for any deduction allowable to the estate or trust under section 1202 (relating to deduction for excess of capital gains over capital losses). In the case of a trust, the deduction allowed by this subsection shall be subject to section 681 (relating to unrelated business income and prohibited transactions).

§ 1.642(c)-1 Charitable Contributions Deduction.—Any part of the gross income of an estate or trust which, by the terms of the will or of the instrument creating the trust—

(a) Is, during the taxable year, paid or permanently set aside for a purpose specified in section 170(c), relating to charitable contributions, or

(b) Is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit,

is allowed as a deduction to the estate or trust in lieu of the deduction authorized by section 170(a). For this purpose, an amount received by an estate or trust which is includible in its gross income as income in respect of a decedent under section 691(a)(1) is deemed "gross income" of the estate or trust. In the case of a trust, the deduction otherwise allowable under section 642(c) and this section is subject to the limitations of section 681 (relating to unrelated business income and prohibited transactions). See section 681 and the regulations thereunder.

§ 1.642(c)-2 Reduction of Charitable Contributions Deductions by Exempt Income.—If an estate or trust pays, permanently sets aside, or uses any amount of its income for the purposes specified in section 642(c) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction under this section is limited to the gross income so paid, permanently set aside, or used. In determining whether such amounts include particular items of income of an estate or trust, if the governing instrument specifically provides as to the source out of which amounts shall be paid, permanently set aside, or used for such purposes, the specific provision controls. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of § 1.643(a)-5 for the method of determining the allocable portion of exempt income and foreign income. For the purpose of this section, the provisions of section 116 (relating to exclusion of dividends) are not taken into account. For examples showing the determination of the character of

an amount deductible under section 642(c), see examples (1) and (2) of § 1.662(b)-2 and paragraph (e) of § 1.662(c)-4.

§ 1.642(c)-3 CAPITAL GAINS INCLUDED IN CHARITABLE CONTRIBUTION.—Where any amount of the income paid, permanently set aside, or used for the purposes specified in section 642(c) is attributable to gain from the sale or exchange of capital assets held for more than six months, the amount of the deduction allowable under section 642(c) must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the charitable, etc., contribution referred to in section 642(c) is deemed to consist of long-term capital gains, see § 1.642(c)-2. For example: Under the terms of the trust instrument, the income of the trust is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year 1954, the trust has long-term capital gains of $100,000 which, although allocable to corpus, are permanently set aside for charitable purposes. The trust includes $100,000 in gross income but is allowed a deduction of $50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of $50,000 under section 642(c) ($100,000 permanently set aside for charitable purposes less $50,000 allowed as a deduction under section 1202 with respect to such $100,000).

§ 1.642(c)-4 CROSS REFERENCE.—For rules applicable to the annual information return that must be filed by certain trusts claiming charitable, etc., deductions under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

§ 1.642(d) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; NET OPERATING LOSS DEDUCTION.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(d) NET OPERATING LOSS DEDUCTION.—The benefit of the deduction for net operating losses provided by section 172 shall be allowed to estates and trusts under regulations prescribed by the Secretary or his delegate.

§ 1.642(d)-1 NET OPERATING LOSS DEDUCTION.—The net operating loss deduction allowed by section 172 is available to estates and trusts generally, with the following exceptions and limitations:

(a) In computing gross income and deductions for the purposes of section 172, a trust shall exclude that portion of the income and deductions attributable to the grantor or another person under sections 671 through 678 (relating to grantors and others treated as substantial owners).

(b) An estate or trust shall not, for the purposes of section 172, avail itself of the deductions allowed by section 642(c) (relating to charitable contributions deductions) and sections 651 and 661 (relating to deductions for distributions).

§ 1.642(e) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; DEDUCTION FOR DEPRECIATION AND DEPLETION.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(e) DEDUCTION FOR DEPRECIATION AND DEPLETION.—An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167(g) and 611(b).

§ 1.642(e)-1 DEPRECIATION AND DEPLETION.—An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(g) and 611(b). For purposes of sections 167(g) and 611(b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

§ 1.642(f) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; AMORTIZATION OF EMERGENCY OR GRAIN STORAGE FACILITIES.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(f) AMORTIZATION OF EMERGENCY OR GRAIN STORAGE FACILITIES.—The benefit of the deductions for amortization of emergency and grain storage facilities provided by sections 168 and 169 shall be allowed to estates and trusts in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiaries and the fiduciary under regulations prescribed by the Secretary or his delegate.

§ 1.642(f)-1 AMORTIZATION OF EMERGENCY OR GRAIN STORAGE FACILITIES.—An estate or trust is allowed amortization deductions with respect to an emergency facility as defined in section 168(d) and with respect to a grain storage facility as defined in section 169(d) in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between the fiduciaries and the beneficiaries of an estate or trust (see sections 167(g) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

§ 1.642(g) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; DISALLOWANCE OF DOUBLE DEDUCTIONS.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(g) DISALLOWANCE OF DOUBLE DEDUCTIONS.—Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction in computing the taxable income of the estate, unless there is filed, within the time and in the manner and form prescribed by the Secretary or his delegate, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

§ 1.642(g)-1 DISALLOWANCE OF DOUBLE DEDUCTIONS; IN GENERAL.—Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable

income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director of internal revenue for the internal revenue district in which the return was filed, for association with the return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642(g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

§ 1.642(g)-2 Deductions Included.—It is not required that the total deductions, or the total amount of any deduction, to which section 642(g) is applicable be treated in the same way. One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes. Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect to a decedent for income tax purposes. However, section 642(g) is applicable to deductions for interest, business expenses, and other items not accrued at the date of the decedent's death so that they are allowable as deductions for estate tax purposes only as administration expenses under section 2053(a)(2). Although deductible under section 2053(a)(3) in determining the value of the taxable estate of a decedent, medical, dental, etc., expenses of a decedent which are paid by the estate of the decedent are not deductible in computing the taxable income of the estate. See section 213(d) and the regulations thereunder for rules relating to the deductibility of such expenses in computing the taxable income of the decedent.

§ 1.642(h) Statutory Provisions; Estates and Trusts; Special Rules for Credits and Deductions; Unused Loss Carryovers and Excess Deductions.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(h) Unused Loss Carryovers and Excess Deductions on Termination Available to Beneficiaries.—If on the termination of an estate or trust, the estate or trust has—

(1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or

(2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year,

416926°—57——19

then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary or his delegate, to the beneficiaries succeeding to the property of the estate or trust.

§ 1.642(h)–1 UNUSED LOSS CARRYOVERS ON TERMINATION OF AN ESTATE OR TRUST.—(a) If, on the final termination of an estate or trust, a net operating loss carryover under section 172 or a capital loss carryover under section 1212 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, the carryover or carryovers are allowed under section 642(h)(1) to the beneficiaries succeeding to the property of the estate or trust. See § 1.641(b)–3 for the determination of when an estate or trust terminates.

(b) The net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust and are taken into account in computing both taxable income and adjusted gross income. The first taxable year of the beneficiary to which the loss shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over each constitute a taxable year for purposes of determining the number of years to which a loss may be carried over. For example: A trust distributes all of its assets to A, the sole remainderman, and terminates on December 31, 1954, when it has a capital loss carryover of $10,000 attributable to transactions during the taxable year 1952. A, who reports on the calendar year basis, otherwise has ordinary income of $10,000 and capital gains of $4,000 for the taxable year 1954. A would offset his capital gains of $4,000 against the capital loss of the trust and, in addition, deduct under section 1211(b) $1,000 on his return for the taxable year 1954. The balance of the capital loss carryover of $5,000 may be carried over only to the years 1955 and 1956. For the treatment of the net operating loss carryover when the last taxable year of the estate or trust is the last taxable year to which such loss can be carried over, see § 1.642(h)–2.

§ 1.642(h)–2 EXCESS DEDUCTIONS ON TERMINATION OF AN ESTATE OR TRUST.—(a) If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction to the beneficiaries succeeding to the property of the estate or trust. The deduction is allowed only in computing taxable income; it is not allowed in computing adjusted gross income. The deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. For example: Assume that a trust distributes all of its assets to B and terminates on December 31, 1954. As of that date it had excess deductions, for example, because of corpus commissions on termination, of $18,000. B, who reported on the calendar year basis, could claim the $18,000 as a deduction for the taxable year 1954. However, if the deduction (when added to his other deduc-

tions) exceeds his gross income, the excess may not be carried over to the year 1955 or subsequent years.

(b) A deduction based upon a net operating loss carryover will never be allowed to beneficiaries under both paragraphs (1) and (2) of section 642(h). Accordingly, a net operating loss deduction which is allowable to beneficiaries succeeding to the property of the estate or trust under the provisions of paragraph (1) of section 642(h) cannot also be considered a deduction for purposes of paragraph (2) of section 642(h) and paragraph (a) of this section. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an "excess deduction" under section 642(h)(2) and paragraph (a) of this section.

(c) Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate or trust for its last taxable year shall not be taken into account again in determining excess deductions on termination of the trust or estate within the meaning of section 642(h)(2) and paragraph (a) of this section (see example in § 1.642(h)-5).

§ 1.642(h)-3 MEANING OF "BENEFICIARIES SUCCEEDING TO THE PROPERTY OF THE ESTATE OR TRUST".—(a) The phrase "beneficiaries succeeding to the property of the estate or trust" means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

(b) With reference to an intestate estate, the phrase means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent. If a decedent's spouse is entitled to a specified dollar amount of property before any distribution to other heirs and next of kin, and if the estate is less than that amount, the spouse is the beneficiary suceeding to the property of the estate or trust to the extent of the deficiency in amount.

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.:

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss

or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay $10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B $10,000.

§ 1.642(h)-4. Allocation.—The carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust (see § 1.642(h)-3) proportionately according to the share of each in the burden of the loss or deductions. A person who qualified as a beneficiary succeeding to the property of an estate or trust with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which he qualifies. The application of this section may be illustrated by the following example:

Example. A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one-half of each item, and the remaining half is divided equally between B and C.

§ 1.642(h)-5 Example.—The application of section 642(h) may be illustrated by the following example:

Example. (a) A decedent dies January 31, 1954, leaving a will which provides for distributing all her estate equally to A and an existing trust for B. The period of administration of the estate terminates on December 31, 1954, at which time all the property of the estate is distributed to A and the trust. A reports his income for tax purposes on a calendar year basis, and the trust reports its income on the basis of a fiscal year ending August 31. During the period of the administration, the estate has the following items of income and deductions:

Taxable interest	$2,500
Business income	3,000
Total	$5,500
Business expenses (including administrative expense allocable to business income)	$5,000

Administrative expenses and corpus commissions not allocable to business income	$9,800
Total deductions	$14,800

It also has a capital loss of $5,000.

(b) Under section 642(h)(1), an unused net operating loss carryover of the estate on termination of $2,000 will be allowable to: A to the extent of $1,000 for his taxable year 1954 and the next four taxable years in accordance with section 172; and to the trust to the extent of $1,000 for its taxable year ending August 31, 1955, and its next four taxable years. The amount of the net operating loss carryover is computed as follows:

Deductions of estate for 1954	$14,800
Less adjustment under section 172(d)(4) (deductions not attributable to a trade or business ($9,800) allowable only to extent of gross income not derived from such trade or business ($2,500))	7,300
Deductions as adjusted	$7,500
Gross income of estate for 1954	5,500
Net operating loss of estate for 1954	$2,000

(No deduction for capital loss of $5,000 under section 172(d)(2).)

Neither A nor the trust will be allowed to carry back any part of the net operating loss made available to them under section 642(h)(1).

(c) Under section 642(h)(2), excess deductions of the estate of $7,300 will be allowed as a deduction to A to the extent of $3,650 for the calendar year 1954 and to the trust to the extent of $3,650 for the taxable year ending August 31, 1955. The deduction of $7,300 for administrative expenses and corpus commissions is the only amount which was not taken into account in determining the net operating loss of the estate ($9,800 of such expenses less $2,500 taken into account).

(d) Under section 642(h)(1), there will be allowable to A a capital loss carryover of $2,500 for his taxable year 1954 and for his next four taxable years in accordance with section 1212. There will be allowable to the trust a similar capital loss carryover of $2,500 for its taxable year ending August 31, 1955, and its next four taxable years (but see paragraph (b) of § 1.643(a)-3).

(e) The carryovers and excess deductions are not allowable directly to B, the trust beneficiary, but to the extent the distributable net income of the trust is reduced by the carryovers and excess deductions B may receive indirect benefit.

§ 1.642(i) STATUTORY PROVISIONS; ESTATES AND TRUSTS; SPECIAL RULES FOR CREDITS AND DEDUCTIONS; DISALLOWANCE OF STANDARD DEDUCTION.

SEC. 642. SPECIAL RULES FOR CREDITS AND DEDUCTIONS. * * *

(i) CROSS REFERENCE.—For disallowance of standard deduction in case of estates and trusts see section 142(b)(4).

§ 1.642(i)-1 DISALLOWANCE OF STANDARD DEDUCTION (CROSS REFERENCE).—The standard deduction is not allowed to estates and trusts (see section 142(b)(4)).

§ 1.643–1 Distributable Net Income; Deduction For Distributions: in General.—The term "distributable net income" has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the benefiiaries. Distributable net income means for any taxable year, the taxable income (as defined in section 63) of the estate or trust, computed with the modifications set forth in §§ 1.643(a)–1 through 1.643(a)–7.

§ 1.643(a) Statutory Provisions; Estates and Trusts; Definition of Distributable Net Income.

SEC. 643. DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D.

(a) Distributable Net Income.—For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) Deduction for distributions.—No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) Deduction for personal exemption.—No deduction shall be taken under section 642(b) (relating to deduction for personal exemptions).

(3) Capital gains and losses.—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(4) Extraordinary dividends and taxable stock dividends.—For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) Tax-exempt interest.—There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) Foreign income.—In the case of a foreign trust, there shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(1) (relating to disallowances of certain deductions).

(7) Dividends.—There shall be included the amount of any dividends excluded from gross income pursuant to section 116 (relating to partial exclusion of dividends received).

If the estate or trust is allowed a deduction under section 642(c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642(c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall

(in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

§ 1.643(a)–1 DEDUCTION FOR DISTRIBUTIONS.—The deduction allowable to a trust under section 651 and to an estate or trust under section 661 for amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income.

§ 1.643(a)–2 DEDUCTION FOR PERSONAL EXEMPTION.—The deduction for personal exemption under section 642(b) is not allowed in the computation of distributable net income.

§ 1.643(a)–3 CAPITAL GAINS AND LOSSES.—(a) Gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are—

(1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,

(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(b) Losses from the sale or exchange of capital assets are excluded in computing distributable net income except to the extent that they enter into the determination of any capital gains that are paid, credited, or required to be distributed to any beneficiary during the taxable year (but see § 1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust).

(c) The deduction under section 1202 (relating to capital gains) is taken into account in computing distributable net income to the extent that it is allocable to capital gains which are paid, permanently set aside, or to be used for the purposes specified in section 642(c). See § 1.642(c)–2 to determine the extent to which the amount so paid, permanently set aside, or to be used consists of capital gains. The deduction for capital gains provided in section 1202 insofar as it is allocable to the remainder of the capital gains is not taken into account.

(d) The application of this section may be illustrated by the following examples:

Example (1). A trust is created to pay the income to A for life, with a discretionary power in the trustee to invade principal for A's benefit. In the taxable year, $10,000 is realized from the sale of securities at a profit, and $10,000 in excess of income is distributed to A. The capital gain is not allocated to A by the trustee. During the taxable year the trustee received and paid out $5,000 of dividends. No other cash was received or on hand during the taxable

year. The capital gain will not ordinarily be included in distributable net income. However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.

Example (2). The result in example (1) would have been the same if the trustee had been directed to pay an annuity of $15,000 a year to A (instead of being directed to pay the income to A with a discretionary power to distribute principal).

Example (3). The trustee of a trust containing Blackacre and other property is directed to hold Blackacre for ten years, and then sell it and distribute its proceeds to A. Any capital gain realized from the sale of Blackacre will be included in distributable net income.

Example (4). A trust instrument directs that the income shall be paid to A, and that the principal shall be distributed to A when he reaches age 35. All capital gains realized in the year of termination will be included in distributable net income. (See § 1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.)

Example (5). If in example (4) the trustee had been directed to distribute half of the principal to A when he reached 35, the capital gain would be included in distributable net income (and in the distribution to A) to the extent the capital gain is allocable to A under the governing instrument and local law. Thus, if the trust assets consisted entirely of 100 shares of corporation M stock and the trustee sold half the shares and distributed the proceeds to A, the entire capital gain would normally be considered as allocated to A. On the other hand, if the trustee sold all the shares and distributed half the proceeds to A, half the capital gain would be considered as allocable to A.

Example (6). If in example (4) the trustee had been directed to pay $10,000 to B before making distribution to A, no portion of the capital gains would be allocable to B since the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1).

§ 1.643(a)–4 EXTRAORDINARY DIVIDENDS AND TAXABLE STOCK DIVIDENDS.—In the case solely of a trust which qualifies under subpart B (sections 651–652) as a "simple trust," there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(d) and paragraph (b) of § 1.665(d)–1 for the treatment of such dividends upon subsequent distribution.

§ 1.643(a)–5 TAX-EXEMPT INTEREST.—(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for

the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)–6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see examples (1) and (2) of § 1.662(b)–2 and paragraph (e) of § 1.662(c)–4.

§ 1.643(a)–6 Foreign Income.—In the case of a foreign trust, there is included in distributable net income gross income from sources without the United States, reduced by disbursements allocable to such foreign income which would have been deductible but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income). See paragraph (b) of § 1.643(a)–5 for rules applicable when an estate or trust is allowed a charitable contributions deduction under section 642(c).

§ 1.643(a)–7 Dividends.—Dividends excluded from gross income under section 116 (relating to partial exclusion of dividends received) are included in distributable net income. For this purpose, adjustments similar to those required by § 1.643(a)–5 with respect to expenses allocable to tax-exempt income and to income included in amounts paid or set aside for charitable purposes are not made. See § 1.642(c)–2.

§ 1.643(b) Statutory Provisions; Estates and Trusts; Definition of Income.

SEC. 643 DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D. * * *

(b) Income.—For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

§ 1.643(b)–1 Definition of "Income."—For purposes of subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954, the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument

directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to "simple" trusts).

§ 1.643(b)–2 DIVIDENDS ALLOCATED TO CORPUS.—Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered "income" for purposes of subparts A, B, C, or D. See section 643(a)(4), § 1.643(a)–4, § 1.643(c)–2, section 665(d) and paragraph (b) of § 1.655(d)–1 for the treatment of such items in the computation of distributable net income.

§ 1.643(c) STATUTORY PROVISIONS; ESTATES AND TRUSTS; DEFINITION OF BENEFICIARY.

SEC. 643. DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D. * * *

(c) BENEFICIARY.—For purposes of this part, the term "beneficiary" includes heir, legatee, devisee.

§ 1.643(c)–1 DEFINITION OF "BENEFICIARY."—An heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate. The following persons are treated as beneficiaries:

(a) Any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)–4.

(b) The grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677(b) out of corpus or out of other than income for the taxable year of the trust.

(c) The trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678(c) out of corpus or out of other than income for the taxable year of the trust.

§ 1.643(c)–2 ILLUSTRATION OF THE PROVISIONS OF SECTION 643.—(a) The provisions of section 643 may be illustrated by the following example:

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	$30,000
Extraordinary dividends allocated to corpus by the trustee in good faith	20,000
Taxable interest	10,000
Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee's commissions and miscellaneous expenses allocable to corpus	5,000

(2) The "income" of the trust determined under section 643(b) which is currently distributable to W is $50,000, consisting of dividends of $30,000, taxable interest of $10,000, and tax-exempt interest of $10,000. The trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 (10,000/50,000× $5,000).

(3) The "distributable net income" determined under section 643(a) amounts to $45,000, computed as follows:

Dividends from domestic corporations		$30,000
Taxable interest		10,000
Nontaxable interest	$10,000	
Less: Expenses allocable thereto	1,000	
		9,000
Total		$49,000
Less: Expenses ($5,000 less $1,000 allocable to tax-exempt interest)		4,000
Distributable net income		$45,000

In determining the distributable net income of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643(a)(3)); the extraordinary dividends allocated to corpus by the trustee in good faith are excluded (section 643(a)(4)); and the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 are included (section 643(a)(5) and (7)).

(b) See paragraph (c) of the example in § 1.661(c)-2 for the computation of distributable net income where there is a charitable contributions deduction.

TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY

§ 1.651(a) STATUTORY PROVISIONS; TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY; DEDUCTION FOR AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY.—

SEC. 651. DEDUCTIONS FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

(a) DEDUCTION.—In the case of any trust the terms of which—

(1) provide that all of its income is required to be distributed currently, and

(2) do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642(c) (relating to deduction for charitable, etc., purposes),

there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently. This section shall not apply in any taxable year in which the trust distributes amounts other than amounts of income described in paragraph (1).

§ 1.651(a)-1 SIMPLE TRUSTS; DEDUCTION FOR DISTRIBUTIONS; IN GENERAL.—Section 651 is applicable only to a trust the governing instrument of which—

(a) Requires that the trust distribute all of its income currently for the taxable year, and

(b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c),

and does not make any distribution other than of current income. A trust to which section 651 applies is referred to in this part as a "simple" trust. Trusts subject to section 661 are referred to as "complex" trusts. A trust may be a simple trust for one year and a complex trust for another year. It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in which it is required to distribute all its income currently and makes no other distributions, whether or not distributions of current income are in fact made. On the other hand a trust is not a complex trust by reason of distributions of amounts other than income unless such distributions are in fact made during the taxable year, whether or not they are required in that year.

§ 1.651(a)–2 Income Required To Be Distributed Currently.—(a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a "simple" trust. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust for treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. For definition of the term "income" see section 643(b) and § 1.643(b)–1.

(b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to "sprinkle" the income among a class of beneficiaries, or among named beneficiaries in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

(c) If in one taxable year of a trust its income for that year is required or permitted to be accumulated, and in another taxable year its

income for the year is required to be distributed currently (and no other amounts are distributed), the trust is a simple trust for the latter year. For example, a trust under which income may be accumulated until a beneficiary is 21 years old, and thereafter must be distributed currently, is a simple trust for taxable years beginning after the beneficiary reaches the age of 21 years in which no other amounts are distributed.

§ 1.651(a)-3 DISTRIBUTION OF AMOUNTS OTHER THAN INCOME.—(a) A trust does not qualify for treatment under section 651 for any taxable year in which it actually distributes corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under section 651 in the year of its termination since in that year actual distributions of corpus would be made.

(b) A trust, otherwise qualifying under section 651, which may make a distribution of corpus in the discretion of the trustee, or which is required under the terms of its governing instrument to make a distribution of corpus upon the happening of a specified event, will be disqualified for treatment under section 651 only for the taxable year in which an actual distribution of corpus is made. For example: Under the terms of a trust, which is required to distribute all of its income currently, half of the corpus is to be distributed to beneficiary A when he becomes 30 years of age. The trust reports on the calendar year basis. On December 28, 1954, A becomes 30 years of age and the trustee distributes half of the corpus of the trust to him on January 3, 1955. The trust will be disqualified for treatment under section 651 only for the taxable year 1955, the year in which an actual distribution of corpus is made.

(c) See section 661 and the regulations thereunder for the treatment of trusts which distribute corpus or claim the charitable contributions deduction provided by section 642(c).

§ 1.651(a)-4 CHARITABLE PURPOSES.—A trust is not considered to be a trust which may pay, permanently set aside, or use any amount for charitable, etc., purposes for any taxable year for which it is not allowed a charitable, etc., deduction under section 642(c). Therefore, a trust with a remainder to a charitable organization is not disqualified for treatment as a simple trust if either (a) the remainder is subject to a contingency, so that no deduction would be allowed for capital gains or other amounts added to corpus as amounts permanently set aside for a charitable, etc., purpose under section 642(c), or (b) the trust receives no capital gains or other income added to corpus for the taxable year for which such a deduction would be allowed.

§ 1.651(a)-5 ESTATES.—Subpart B has no application to an estate.

§ 1.651(b) STATUTORY PROVISIONS; TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY; LIMITATION ON DEDUCTION FOR AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY.

SEC. 651. DEDUCTION FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY. * * *

(b) LIMITATION ON DEDUCTION.—If the amount of income required to be distributed currently exceeds the distributable net income of the trust for

the taxable year, the deduction shall be limited to the amount of the distributable net income. For this purpose, the computation of distributable net income shall not include items of income which are not included in the gross income of the trust and the deductions allocable thereto.

§ 1.651(b)–1 DEDUCTION FOR DISTRIBUTIONS TO BENEFICIARIES.—In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose the amount of income required to be distributed currently, or distributable net income, whichever is applicable, does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust. For determination of the character of the income required to be distributed currently, see § 1.652(b)–2. Accordingly, for the purposes of determining the deduction allowable to the trust under section 651, distributable net income is computed without the modifications specified in paragraphs (5), (6), and (7) of section 643(a), relating to tax-exempt interest, foreign income, and excluded dividends. For example: Assume that the distributable net income of a trust as computed under section 643(a) amounts to $99,000 but includes nontaxable income of $9,000. Then distributable net income for the purpose of determining the deduction allowable under section 651 is $90,000 ($99,000 less $9,000 nontaxable income).

§ 1.652(a) STATUTORY PROVISIONS; TRUSTS WHICH DISTRIBUTE CURRENT INCOME ONLY; INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES.

SEC. 652. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

(a) INCLUSION.—Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

§ 1.652(a)–1 SIMPLE TRUSTS; INCLUSION OF AMOUNTS IN INCOME OF BENEFICIARIES.—Subject to the rules in §§ 1.652(a)–2 and 1.652(b)–1, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed. Thus, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust. See § 1.642(a)(3)–2 with respect to time of receipt of dividends. See § 1.652(c)–1 for treatment of amounts required to be distributed where a beneficiary and the trust have different taxable years. The term

"income required to be distributed currently" includes income required to be distributed currently which is in fact used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

§ 1.652(a)–2 Distributions in Excess of Distributable Net Income.—If the amount of income required to be distributed currently to beneficiaries exceeds the distributable net income of the trust (as defined in section 643(a)), each beneficiary includes in his gross income an amount equivalent to his proportinate share of such distributable net income. Thus, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is $99,000, A will receive $66,000 and B, $33,000. However, if the distributable net income, as determined under section 643(a) is only $90,000, A will include two-thirds ($60,000) of that sum in his gross income, and B will include one-third ($30,000) in his gross income. See §§ 1.652(b)–1 and 1.652(b)–2, however, for amounts which are not includible in the gross income of a beneficiary because of their tax-exempt character.

§ 1.652(b) Statutory Provisions; Trusts Which Distribute Current Income Only; Character of Amounts in the Hands of Beneficiaries.

SEC. 652. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY. * * *

(b) Character of Amounts.—The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.652(b)–1 Character of Amounts.—In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)–1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)–1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 and the dividend exclusion under section 116. The tax treatment of amounts determined under § 1.652(a)–1 depends upon the beneficiary's status with respect to them, not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

§ 1.652(b)–2 Allocation of Income Items.—(a) The amounts specified in § 1.652(a)–1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the

trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000, and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example—

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay half the income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay all of one class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

§ 1.652(b)-3 Allocation of Deductions.—Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

(a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642(e)-1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

(c) Examples of expenses which are considered as not directly attributable to a specific class of income are trustee's commissions, the rental of safe deposit boxes, and State income and personal property taxes.

(d) To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b), except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.

§ 1.652(c) Statutory Provisions; Trusts Which Distribute Current Income Only; Inclusion of Amounts in Gross Income of Beneficiaries; Different Taxable Years.

SEC. 652. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY. * * *

(c) Different Taxable Years.—If the taxable year of a beneficiary is different from that of the trust, the amount which the beneficiary is required to include in gross income in accordance with the provisions of this section shall be based upon the amount of income of the trust for any taxable year or years of the trust ending within or with his taxable year.

§ 1.652(c)-1 Different Taxable Years.—If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income in accordance with section 652(a) and (b) is based on the in-

come of the trust for any taxable year or years ending with or within his taxable year. This rule applies to taxable years of normal duration as well as to so-called short taxable years. Income of the trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.652(c)-2 Death of Individual Beneficiaries.—If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends. Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

§ 1.652(c)-3 Termination of Existence of Other Beneficiaries.—If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 652(a) in its gross income for its last taxable year is computed with reference to §§ 1.652(c)-1 and 1.652(c)-2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.652(c)-4 Illustration of the Provisions of Sections 651 and 652.—The rules applicable to a trust required to distribute all of its income currently and to its beneficiaries may be illustrated by the following example:

Example.—(a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation	5,000

(b) The income of the trust for fiduciary accounting purposes is $92,400, computed as follows:

Rents		$25,000
Dividends		50,000
Tax-exempt interest		25,000
Total		$100,000
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions allocable to income account	2,600	
		7,600
Income computed under section 643(b)		$92,400

One-half ($46,200) of the income of $92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643(a) is $91,100, determined as follows (cents are disregarded in the computation):

Rents		$25,000
Dividends		50,000
Tax-exempt interest	$25,000	
Less: Expenses allocable thereto (25,000/100,000×$3,900)	975	
		24,025
Total		$99,025
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions ($3,900 less $975 allocable to tax-exempt interest)	2,925	
		7,925
Distributable net income		$91,100

In computing the distributable net income of $91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 were included (section 643(a)(5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167(g) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651(a) for distributions to the beneficiaries is $67,025, computed as follows:

Distributable net income computed under section 643(a) (see paragraph (c))		$91,100
Less:		
Tax-exempt interest as adjusted	$24,025	
Dividend exclusion	50	
		24,075
Distributable net income as determined under section 651(b)		$67,025

Since the amount of the income ($92,400) required to be distributed currently by the trust exceeds the distributable net income ($67,025) as computed under section 651(b), the deduction allowable under section 651(a) is limited to the distributable net income of $67,025.

(e) The taxable income of the trust is $7,200 computed as follows:

Rents		$25,000
Dividends ($50,000 less $50 exclusion)		49,950
Long-term capital gains		15,000
Gross income		$89,950
Deductions:		
Rental expenses	$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	300	
		82,750
Taxable income		$7,200

The trust is not allowed a deduction for the portion ($975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

(f) In determining the character of the amounts includible in the gross income of A and B, it is assumed that the trustee elects to allocate to rents the expenses not directly attributable to a specific item of income other than the portion ($975) of such expenses allocated to tax-exempt interest. The allocation of expenses among the items of income is shown below:

	Rents	*Dividends*	*Tax-exempt interest*	*Total*
Income for trust accounting purposes	$25,000	$50,000	$25,000	$100,000
Less:				
Rental expenses	5,000	--------	--------	5,000
Trustee's commissions	2,925	--------	975	3,900
Total deductions	$7,925	0	$975	$8,900
Character of amounts in the hands of the beneficiaries	$17,075	$50,000	$24,025	*$91,100

*Distributable net income.

Inasmuch as the income of the trust is to be distributed equally to A and B, each is deemed to have received one-half of each item of income; that is, rents of $8,537.50, dividends of $25,000, and tax-exempt interest of $12,012.50. The dividends of $25,000 allocated to each beneficiary are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion provided by section 116 and the dividend received credit allowed under section 34. Also, each beneficiary is allowed a deduction of $2,500 for depreciation of rental property attributable to the portion (one-half) of the income of the trust distributed to him.

§ 1.661(a) STATUTORY PROVISIONS; ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS; DEDUCTION FOR AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY AND OTHER AMOUNTS DISTRIBUTED.

SEC. 661. DEDUCTION FOR ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

(a) DEDUCTION.—In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—

(1) any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and

(2) any other amounts properly paid or credited or required to be distributed for such taxable year;

but such deduction shall not exceed the distributable net income of the estate or trust.

§ 1.661(a)-1 ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS; GENERAL.—Subpart C of part I, subchapter J, chapter 1, of the Internal Revenue Code of 1954 is applicable to all decedents' estates and their beneficiaries, and to trusts and their beneficiaries other than trusts subject to the provisions of subpart B of part I (relating to trusts which distribute current income only, or "simple" trusts). A trust which is required to distribute amounts other than income during the taxable year may be subject to subpart B, and not subpart C, in the absence of an actual distribution of amounts other than income during the taxable year. See §§ 1.651(a)-1 and 1.651(a)-3. A trust to which subpart C is applicable is referred to as a "complex" trust in this part. Section 661 has no application to amounts excluded under section 663(a).

§ 1.661(a)-2 DEDUCTION FOR DISTRIBUTIONS TO BENEFICIARIES.—(a) In computing the taxable income of an estate or trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of—

(1) The amount of income for the taxable year which is required to be distributed currently, and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year.

However, the total amount deductible under section 661(a) cannot exceed the distributable net income as computed under section 643(a) and as modified by section 661(c). See § 1.661(c)-1.

(b) The term "income required to be distributed currently" includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. See § 1.651(a)-2 which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.

(c) The term "any other amounts properly paid or credited or required to be distributed" includes all amounts properly paid, credited, or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is

not paid out of income for the taxable year, and a distribution of property in kind (see paragraph (f) of this section). However, see section 663(a) and regulations thereunder for distributions which are not included. Where the income of an estate or trust may be accumulated or distributed in the discretion of the fiduciary, or where the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution would qualify under section 661(a)(2). The term also includes an amount applied or distributed for the support of a dependent of a grantor or of a trustee or cotrustee under the circumstances described in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.

(d) The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

(e) The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" do not include amounts required to be paid by a decedent's estate pursuant to a court order or decree as an allowance or award under local law for the support of the decedent's widow or other dependent for a limited period during the administration of the estate, except to the extent such amounts are payable out of and chargeable to income under the order or decree or local law. The term "any other amounts properly paid or credited or required to be distributed" does not include the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

(f) If property is paid, credited, or required to be distributed in kind—

(1) No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

(2) In determining the amount deductible by the trust or estate and includible in the gross income of the beneficiary the property distributed in kind is taken into account at its fair market value at the time it was distributed, credited, or required to be distributed.

(3) The basis of the property in the hands of the beneficiary is its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value is included in the gross income of the beneficiary. To the extent that the value of property distributed in kind is not included in the gross income of the beneficiary, its basis in the hands of the beneficiary is governed by the rules in sections 1014 and 1015 and the regulations thereunder. For this purpose, if the total value of cash and property distributed, credited, or required to be distributed in kind to a beneficiary in any taxable year exceeds the amount includible in his gross income for that year, the value of the property other than cash is normally considered as includible in his gross income only to the extent that the amount includible exceeds the cash paid, credited, or required to be

distributed to the beneficiary in that year. Further, to the extent that the value of different items of property other than cash is includible in the gross income of a beneficiary in accordance with the preceding sentence, a pro rata portion of the total value of each item of property distributed, credited, or required to be distributed is normally considered as includible in the beneficiary's gross income.

§ 1.661(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS; CHARACTER OF AMOUNTS DISTRIBUTED TO BENEFICIARIES.

SEC. 661. DEDUCTION FOR ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS. * * *

(b) CHARACTER OF AMOUNTS DISTRIBUTED.—The amount determined under subsection (a) shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.661(b)-1 CHARACTER OF AMOUNTS DISTRIBUTED; IN GENERAL.—In the absence of specific provisions in the governing instrument for the allocation of different classes of income, or unless local law requires such an allocation, the amount deductible for distributions to beneficiaries under section 661(a) is treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. For example, if a trust has distributable net income of $20,000, consisting of $10,000 each of taxable interest and royalties and distributes $10,000 to beneficiary A, the deduction of $10,000 allowable under section 661(a) is deemed to consist of $5,000 each of taxable interest and royalties, unless the trust instrument specifically provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation. See also § 1.661(c)-1.

§ 1.661(b)-2 CHARACTER OF AMOUNTS DISTRIBUTED WHEN CHARITABLE CONTRIBUTIONS ARE MADE.—In the application of the rule stated in § 1.661(b)-1, the items of deduction which enter into the computation of distributable net income are allocated among the items of income which enter into the computation of distributable net income in accordance with the rules set forth in § 1.652(b)-3, *except* that, in the absence of specific provisions in the governing instrument, or unless local law requires a different apportionment, amounts paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) are *first* ratably apportioned among each class of items of income entering into the computation of the distributable net income of the estate or trust, in accordance with the rules set out in paragraph (b) of § 1.643(a)-5.

§ 1.661(c) STATUTORY PROVISIONS; ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS; LIMITATION ON DEDUCTION FOR AMOUNTS DISTRIBUTED TO BENEFICIARIES.

SEC. 661. DEDUCTION FOR ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS. * * *

(c) LIMITATION ON DEDUCTION.—No deduction shall be allowed under subsection (a) in respect of any portion of the amount allowed as a deduction under that subsection (without regard to this subsection) which is treated under subsection (b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust.

§ 1.661(c)–1 LIMITATION ON DEDUCTION.—An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if a trust has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

§ 1.661(c)–2 ILLUSTRATION OF THE PROVISIONS OF SECTION 661.—The provisions of section 661 may be illustrated by the following example:

Example.—(a) Under the terms of a trust, which reports on the calendar year basis, $10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes $10,000 to charity and in his discretion distributes $15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is $40,000, computed as follows:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Total	$50,000

Less:		
Rental expenses	$2,000	
Depreciation	3,000	
Trustee's commissions	5,000	
		10,000
Income as computed under section 643(b)		$40,000

(c) The distributable net income of the trust as computed under section 643(a) is $30,000, determined as follows:

Rents			$20,000
Dividends			10,000
Partially tax-exempt interest			10,000
Fully tax-exempt interest		$10,000	
Less:			
Expenses allocable thereto (10,000/50,000×$5,000)	$1,000		
Charitable contributions allocable thereto (10,000/50,000×$10,000)	2,000		
		3,000	
			7,000
Total			$47,000
Deductions:			
Rental expenses		$2,000	
Depreciation of rental property		3,000	
Trustee's commissions ($5,000 less $1,000 allocated to tax-exempt interest)		4,000	
Charitable contributions ($10,000 less $2,000 allocated to tax-exempt interest)		8,000	
			17,000
Distributable net income (section 643(a))			$30,000

(d) The character of the amounts distributed under section 661(a), determined in accordance with the rules prescribed in §§ 1.661(b)–1 and 1.661(b)–2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental income	Taxable dividends	Excluded dividends	Partially tax-exempt interest	Tax-exempt interest	Total
Trust income	$20,000	$9,950	$50	$10,000	$10,000	$50,000
Less:						
Charitable contributions	4,000	2,000		2,000	2,000	10,000
Rental expenses	2,000					2,000
Depreciation	3,000					3,000
Trustee's commissions	4,000				1,000	5,000
Total deductions	$13,000	$2,000	0	$2,000	$3,000	$20,000
Distributable net income	$7,000	$7,950	$50	$8,000	$7,000	$30,000
Amounts deemed distributed under section 661(a) before applying the limitation of section 661(c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each item of income of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is $11,375 computed as follows:

Rental income		$20,000
Dividends ($10,000 less $50 exclusion)		9,950
Partially tax-exempt interest		10,000
Gross income		$39,950
Deductions:		
Rental expenses	$ 2,000	
Depreciation of rental property	3,000	
Trustee's commissions	4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	100	
		28,575
Taxable income		$11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction ($2,000) and trustee's commissions ($1,000) which are treated under section 661(b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of $4,000 deemed to have been distributed to A under section 661(a), $25 (25/50ths of $50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of $3,500 rental income, $3,975 of dividends, and $4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of $5,975 ($9,950 less $3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of $6,000 ($10,000 less $4,000 deemed distributed to A) included in gross income.

(g) Dividends of $4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 34.

§ 1.662(a) Statutory Provisions; Estates and Trusts Which May Accumulate Income or Which Distribute Corpus; Inclusion of Amounts in Gross Income of Beneficiaries.

SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS.

(a) Inclusion.—Subject to subsection (b), there shall be included in the gross income of a beneficiary to whom an amount specified in section 661(a) is paid, credited, or required to be distributed (by an estate or trust described in section 661), the sum of the following amounts:

(1) AMOUNTS REQUIRED TO BE DISTRIBUTED CURRENTLY.—The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642(c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

(2) OTHER AMOUNTS DISTRIBUTED.—All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of—

(A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and

(B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries

exceeds the distributable net income of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (reduced by the amounts specified in (A)) as the other amounts properly paid, credited or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

§ 1.662(a)-1 INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND COMPLEX TRUSTS; GENERAL.—There is included in the gross income of a beneficiary of an estate or complex trust the sum of—

(1) Amounts of income required to be distributed currently to him, and

(2) All other amounts properly paid, credited, or required to be distributed to him

by the estate or trust. The preceding sentence is subject to the rules contained in § 1.662(a)-2 (relating to currently distributable income), § 1.662(a)-3 (relating to other amounts distributed), and §§ 1.662(b)-1 and 1.662(b)-2 (relating to character of amounts). Section 662 has no application to amounts excluded under section 663(a).

§ 1.662(a)-2 CURRENTLY DISTRIBUTABLE INCOME.—(a) There is first included in the gross income of each beneficiary under section 662(a)(1) the amount of income for the taxable year of the estate or trust required to be distributed currently to him, subject to the provisions of paragraph (b) of this section. Such amount is included in the beneficiary's gross income whether or not it is actually distributed.

(b) If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643(a) but computed without taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642(c)) of the estate or trust, then there is included in the gross income of each

beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries.

(c) The phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent the amount is satisfied out of income for the taxable year. Thus, an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643(b)) not paid, credited, or required to be distributed to other beneficiaries for the taxable year. If an annuity or a portion of an annuity is deemed under this paragraph to be income required to be distributed currently, it is treated in all respects in the same manner as an amount of income actually required to be distributed currently.

(d) If an annuity is paid, credited, or required to be distributed tax free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be treated as income paid, credited, or required to be distributed currently to the extent it is made out of income.

(e) The application of the rules stated in this section may be illustrated by the following examples:

Example (1). (1) Assume that under the terms of the trust instrument $5,000 is to be paid to X charity out of income each year; that $20,000 of income is currently distributable to A; and that an annuity of $12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of $30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B). Since the charitable contribution is out of income, the amount of income available for B's annuity is only $5,000. The distributable net income of the trust computed under section 643(a) without taking into consideration the charitable contributions deduction of $5,000 as provided by section 661(a)(1), is $30,000. Since the amounts treated as distributed currently of $25,000 do not exceed the distributable net income (as modified) of $30,000, A is required to include $20,000 in his gross income and B is required to include $5,000 in his gross income under section 662(a)(1).

Example (2). Assume the same facts as in paragraph (1) of example (1), except that the trust has, in addition, $10,000 of administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662(a)(1)

total $25,000 ($20,000 to A and $5,000 to B), since trust income under section 643(b) remains the same as in example (1). Distributable net income of the trust computed under section 643(a) but without taking into account the charitable contributions deduction of $5,000 as provided by section 662(a)(1) is only $20,000. Since the amounts treated as distributed currently of $25,000 exceed the distributable net income (as so computed) of $20,000, A is required to include $16,000 (20,000/25,000 of $20,000) in his gross income and B is required to include $4,000 (5,000/25,000 of $20,000) in his gross income under section 662(a)(1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

§ 1.662(a)-3 Other Amounts Distributed.—(a) There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)-2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

(b) Some of the payments to be included under paragraph (a) of this section are: (1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of § 1.661(a)-2; and (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.

(c) If the sum of the amounts of income required to be distributed currently (as determined under § 1.662(a)-2) and other amounts properly paid, credited, or required to be distributed (as determined under paragraph (a) of this section) exceeds distributable net income (as defined in section 643(a)), then such other amounts properly paid, credited, or required to be distributed are included in gross income of the beneficiary but only to the extent of the excess of such distributable net income over the amounts of income required to be distributed currently. If the other amounts are paid, credited, or required to be distributed to more than one beneficiary, each beneficiary includes in gross income his proportionate share of the amount includible in gross income pursuant to the preceding sentence. The proportionate share is an amount which bears the same ratio to distributable net income (reduced by amounts of income required to be distributed currently) as the other amounts (as determined under paragraphs (a)

and (d) of this section) distributed to the beneficiary bear to the other amounts distributed to all beneficiaries. For treatment of excess distributions by trusts, see sections 665 to 668, inclusive, and the regulations thereunder.

(d) The application of the rules stated in this section may be illustrated by the following example:

Example.—The terms of a trust require the distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. Distributable net income is $20,000. The trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, he distributes $3,000 each to B, C, and D, and also distributes an additional $5,000 to A. A includes $10,000 in income under section 662(a)(1). The "other amounts distributed" amount to $14,000, includible in the income of the recipients to the extent of $10,000, distributable net income less the income currently distributable to A. A will include an additional $3,571 (5,000/14,000 × $10,000) in income under this section, and B, C, and D will each include $2,143 (3,000/14,000×$10,000).

§ 1.662(a)-4 Amounts Used in Discharge of a Legal Obligation.—Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

§ 1.662(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS WHICH MAY ACCUMULATE INCOME OR WHICH DISTRIBUTE CORPUS; CHARACTER OF AMOUNTS IN THE HANDS OF BENEFICIARIES.

SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS. * * *

(b) CHARACTER OF AMOUNTS.—The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

§ 1.662(b)–1 CHARACTER OF AMOUNTS; WHEN NO CHARITABLE CONTRIBUTIONS ARE MADE.—In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)–1 through 1.662(a)–4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose the principles contained in § 1.652(b)–1 shall apply.

§ 1.662(b)–2 CHARACTER OF AMOUNTS; WHEN CHARITABLE CONTRIBUTIONS ARE MADE.—When a charitable contribution is made, the principles contained in §§ 1.652(b)–1 and 1.662(b)–1 generally apply. However, before the allocation of other deductions among the items of distributable net income, the charitable contributions deduction allowed under section 642(c) is (in the absence of specific allocation under the terms of the governing instrument or the requirement under local law of a different allocation) allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of § 1.643(a)–5. In the application of the preceding sentence, for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently. The application of this section may be illustrated by the following examples (of which example (1) is illustrative of the preceding sentence):

Example (1). (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may

either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.

(b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).

(c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.

(d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See sections 665 through 668 (subpart D) for application of the throwback provisions to the distribution made to B.

Example (2). The net income of a trust is payable to A for life, with the remainder to a charitable organization. Under the terms of the trust instrument and local law capital gains are added to corpus. During the taxable year the trust receives dividends of $10,000 and realized a long-term capital gain of $10,000, for which a long-term capital gain deduction of $5,000 is allowed under section 1202. Since under the trust instrument and local law the capital gains are allocated to the charitable organization, and since the capital gain deduction is directly attributable to the capital gain, the charitable contributions deduction and the capital gain deduction are both allocable to the capital gain, and dividends in the amount of $10,000 are allocable to A.

§ 1.662(c) STATUTORY PROVISIONS; ESTATES AND TRUSTS WHICH MAY ACCUMULATE INCOME OR WHICH DISTRIBUTE CORPUS; DIFFERENT TAXABLE YEARS.

SEC. 662. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF ESTATES AND TRUSTS ACCUMULATING INCOME OR DISTRIBUTING CORPUS. * * *

(c) DIFFERENT TAXABLE YEARS.—If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be based on the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate or trust ending within or with his taxable year.

§ 1.662(c)-1 DIFFERENT TAXABLE YEARS.—If a beneficiary has a different taxable year (as defined in section 441 or 442) from the tax-

able year of an estate or trust, the amount he is required to include in gross income in accordance with section 662(a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. This rule applies as to so-called short taxable years as well as taxable years of normal duration. Income of an estate or trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

§ 1.662(c)–2 DEATH OF INDIVIDUAL BENEFICIARY.—If an amount specified in section 662(a)(1) or (2) is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 662 for the taxable year of the estate or trust in which his last taxable year ends. Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

§ 1.662(c)–3 TERMINATION OF EXISTENCE OF OTHER BENEFICIARIES.—If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 662(a) in its gross income for the last taxable year is computed with reference to §§ 1.662(c)–1 and 1.662(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

§ 1.662(c)–4 ILLUSTRATION OF THE PROVISIONS OF SECTIONS 661 AND 662.—The provisions of sections 661 and 662 may be illustrated in general by the following example:

Example. (a) Under the terms of a testamentary trust, one-half of the trust income is to be distributed currently to W, the decedent's wife, for her life. The remaining trust income may, in the trustee's discretion, either be paid to D, the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of W and the principal will then be payable to D. No provision is made in the trust instrument with respect to depreciation of rental property. Capital gains are allocable to the principal account under the applicable local law. The trust and both beneficiaries file returns on the calendar year basis. The records of the

fiduciary show the following items of income and deduction for the taxable year 1955:

Rents	$50,000
Dividends of domestic corporations	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	10,000
Capital gains (long term)	20,000
Depreciation of rental property	10,000
Expenses attributable to rental income	15,400
Trustee's commissions allocable to income account	2,800
Trustee's commissions allocable to principal account	1,100

(b) The income for trust accounting purposes is $111,800, and the trustee distributes one-half ($55,900) to W and in his discretion makes a contribution of one-quarter ($27,950) to charity X and distributes the remaining one-quarter ($27,950) to D. The total of the distributions to beneficiaries is $83,850, consisting of (1) income required to be distributed currently to W of $55,900 and (2) other amounts properly paid or credited to D of $27,950. The income for trust accounting purposes of $111,800 is determined as follows:

Rents		$ 50,000
Dividends		50,000
Tax-exempt interest		20,000
Partially tax-exempt interest		10,000
Total		$130,000
Less:		
Rental expenses	$15,400	
Trustee's commissions allocable to income account	2,800	
		18,200
Income as computed under section 643(b)		$111,800

(c) The distributable net income of the trust as computed under section 643(a) is $82,750, determined as follows:

Rents			$ 50,000
Dividends			50,000
Partially tax-exempt interest			10,000
Tax-exempt interest		$20,000	
Less:			
Trustee's commissions allocable thereto (20,000/130,000 of $3,900)	$600		
Charitable contributions allocable thereto (20,000/130,000 of $27,950)	4,300		
		4,900	
			15,100
Total			$125,100
Deductions:			
Rental expenses		$15,400	
Trustee's commissions ($3,900 less $600 allocated to tax-exempt interest)		3,300	
Charitable deduction ($27,950 less $4,300 attributable to tax-exempt interest)		23,650	
			42,350
Distributable net income			$82,750

In computing the distributable net income of $82,750, the taxable income of the trust was computed with the following modifications:

No deductions were allowed for distributions to beneficiaries and for personal exemption of the trust (section 643(a)(1) and (2)): capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); and the tax-exempt interest (as adjusted for expenses and charitable contributions) and the dividend exclusion of $50 were included (section 643(a)(5) and (7)).

(d) Inasmuch as the distributable net income of $82,750 as determined under section 643(a) is less than the sum of the amounts distributed to W and D of $83,850, the deduction allowable to the trust under section 661(a) is such distributable net income as modified under section 661(c) to exclude therefrom the items of income not included in the gross income of the trust, as follows:

Distributable net income		$82, 750
Less:		
Tax-exempt interest (as adjusted for expenses and the charitable contributions)	$15, 100	
Dividend exclusion allowable under section 116	50	
		15, 150
Deduction allowable under section 661(a)		$67, 600

(e) For the purpose of determining the character of the amounts deductible under section 642(c) and section 661(a), the trustee elected to offset the trustee's commissions (other than the portion required to be allocated to tax-exempt interest) against the rental income. The following table shows the determination of the character of the amounts deemed distributed to beneficiaries and contributed to charity:

	Rents	Taxable dividends	Excluded dividends	Tax-exempt interest	Partially tax-exempt interest	Total
Trust income	$50, 000	$49, 950	$50	$20, 000	$10, 000	$130, 000
Less:						
Charitable contribution	10, 750	10, 750		4, 300	2, 150	27, 950
Rental expenses	15, 400					15, 400
Trustee's commissions	3, 300			600		3, 900
Total deductions	$29, 450	$10, 750	0	$4, 900	$2, 150	$47, 250
Amounts distributable to beneficiaries	$20, 550	$39, 200	$50	$15, 100	$7, 850	$82, 750

The character of the charitable contribution is determined by multiplying the total charitable contribution ($27,950) by a fraction consisting of each item of trust income, respectively, over the total trust income, except that no part of the dividends excluded from gross income are deemed included in the charitable contribution. For example, the charitable contribution is deemed to consist of rents of $10,750 (50,000/130,000×$27,950).

(f) The taxable income of the trust is $9,900 determined as follows:

Rental income		$50,000
Dividends ($50,000 less $50 exclusion)		49,950
Partially tax-exempt interest		10,000
Capital gains		20,000
Gross income		$129,950
Deductions:		
Rental expenses	$15,400	
Trustee's commissions	3,300	
Charitable contributions	23,650	
Capital gain deduction	10,000	
Distributions to beneficiaries	67,600	
Personal exemption	100	
		120,050
Taxable income		$9,900

(g) In computing the amount includible in W's gross income under section 662(a) (1), the $55,900 distribution to her is deemed to be composed of the following proportions of the items of income deemed to have been distributed to the beneficiaries by the trust (see paragraph (e) of this section):

Rents (20,550/82,750×$55,900)	$13,882
Dividends (39,250/82,750×$55,900)	26,515
Partially tax-exempt interest (7,850/82,750×$55,900)	5,303
Tax-exempt interest (15,100/82,750×$55,900)	10,200
Total	$55,900

Accordingly, W will exclude $10,200 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-half of the total depreciation deduction, or $5,000.

(h) Inasmuch as the sum of the amount of income required to be distributed currently to W ($55,900) and the other amounts properly paid, credited, or required to be distributed to D ($27,950) exceeds the distributable net income ($82,750) of the trust as determined under section 643(a), D is deemed to have received $26,850 ($82,750 less $55,900) for income tax purposes. The character of the amounts deemed distributed to her is determined as follows:

Rents (20,550/82,750×$26,850)	$6,668
Dividends (39,250/82,750×$26,850)	12,735
Partially tax-exempt interest (7,850/82,750×$26,850)	2,547
Tax-exempt interest (15,100/82,750×$26,850)	4,900
Total	$26,850

Accordingly, D will exclude $4,900 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections

34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-fourth of the total depreciation deduction, or $2,500.

(i) [Reserved]

(j) The remaining $2,500 of the depreciation deduction is allocated to the amount distributed to charity X and is hence nondeductible by the trust, W, or D. (See § 1.642(e)–1.)

§ 1.663(a) STATUTORY PROVISIONS; ESTATES AND COMPLEX TRUSTS; SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662; EXCLUSIONS.

SEC. 663. SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662.

(a) EXCLUSIONS.—There shall not be included as amounts falling within section 661(a) or 662(a)—

(1) GIFTS, BEQUESTS, ETC.—Any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments. For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.

(2) CHARITABLE, ETC., DISTRIBUTIONS.—Any amount paid or permanently set aside or otherwise qualifying for the deduction provided in section 642(c) (computed without regard to section 681).

(3) DENIAL OF DOUBLE DEDUCTION.—Any amount paid, credited, or distributed in the taxable year, if section 651 or section 661 applied to such amount for a preceding taxable year of an estate or trust because credited or required to be distributed in such preceding taxable year.

§1.663(a)–1 SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662; EXCLUSIONS; GIFTS, BEQUESTS, ETC.—(a) *In general.*—A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) *Definition of a gift or bequest of a specific sum of money or of specific property.*—(1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a deced-

ent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example (1). Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and X. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A and transferred the X company stock to W. No other distributions to beneficiaries were made during the taxable year. The distributions to A and W qualify as exclusions within the meaning of section 663(a)(1).

Example (2). Under the terms of a will, the testator's estate was to be divided equally between A and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $50,000 for the taxable year 1954. In accordance with an agreement among the beneficiaries that part of the assets of the estate would be distributed in kind to

the beneficiaries, stock in corporation X was distributed to A during 1954. The fair market value of the stock was $40,000 on the date of distribution. No other distribution was made during the year. The distribution does not qualify as an exclusion within the meaning of section 663(a)(1), since it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of section 661(a) and section 662(a) (see paragraph (c) of § 1.661(a)-2).

Example (3). Under the terms of a trust instrument, income is to be accumulated during the minority of A. Upon A's reaching the age of 21, $10,000 is to be distributed to B out of income or corpus. Also at that time, $10,000 is to be distributed to C out of the accumulated income and the remainder of the accumulations are to be paid to A. A is then to receive all the income until he is 25, when the trust is to terminate. Only the distribution to B would qualify for exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments*.—(1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments—

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661(a)-2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed to the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.

Example (3). A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

§ 1.663(a)-2 CHARITABLE, ETC., DISTRIBUTIONS.—Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under

that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section the deduction provided in section 642(c) is computed without regard to the limitation provided by section 681 (concerning unrelated business income and prohibited transactions).

§ 1.663(a)-3 Denial of Double Deduction.—No amount deemed to have been distributed to a beneficiary in a preceding year under section 651 or 661 is included in amounts falling within section 661(a) or 662(a). For example, assume that all of the income of a trust is required to be distributed currently to beneficiary A and both the trust and A report on the calendar year basis. For administrative convenience, the trustee distributes in January and February 1956 a portion of the income of the trust required to be distributed in 1955. The portion of the income for 1955 which was distributed by the trust in 1956 may not be claimed as a deduction by the trust for 1956 since it is deductible by the trust and includible in A's gross income for the taxable year 1955.

§ 1.663(b) Statutory Provisions; Estates and Complex Trusts; Special Rules Applicable to Sections 661 and 662; Distributions in First Sixty-five Days of Taxable Year.

SEC. 663. SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662. * * *

(b) Distributions in First Sixty-five Days of Taxable Year.—

(1) General rule.—If within the first 65 days of any taxable year of a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.

(2) Limitation.—This subsection shall apply only to a trust—

(A) which was in existence prior to January 1, 1954,

(B) which, under the terms of its governing instrument, may not distribute in any taxable year amounts in excess of the income of the preceding taxable year, and

(C) on behalf of which the fiduciary elects to have this subsection apply.

The election authorized by subparagraph (C) shall be made for the first taxable year to which this part is applicable in accordance with such regulations as the Secretary or his delegate shall prescribe and shall be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). If such election is made with respect to a taxable year, this subsection shall apply to all amounts properly paid or credited within the first 65 days of all subsequent taxable years of such trust.

§ 1.663(b)-1 Distributions in First Sixty-five Days of Taxable Year; Scope.—The fiduciary of a trust may elect under section 663(b) to treat distributions within the first 65 days of the taxable year of the trust as amounts which were paid or credited on the last day of the preceding taxable year, if—

(a) The trust was in existence prior to January 1, 1954;

(b) An amount in excess of the income of the immediately preceding taxable year may not (under the terms of the governing instrument) be distributed in any taxable year; and

(c) The fiduciary elects (as provided in § 1.663(b)-2) to have section 663(b) apply.

§ 1.663(b)-2 ELECTION.—(a) The election under section 663(b) shall be made in a statement attached to the return for the first taxable year of the trust subject to the Internal Revenue Code of 1954. The election must be made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

(b) If an election is made by a fiduciary, the election is irrevocable for the taxable year for which the election is made and for all future taxable years.

(c) If an election is made with respect to a taxable year, this section applies to all amounts properly paid or credited within the first 65 days of such year and all subsequent taxable years of the trust.

§ 1.663(c) STATUTORY PROVISIONS; ESTATES AND COMPLEX TRUSTS; SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662; SEPARATE SHARES TREATED AS SEPARATE TRUSTS.

SEC. 663. SPECIAL RULES APPLICABLE TO SECTIONS 661 AND 662. * * *

(c) SEPARATE SHARES TREATED AS SEPARATE TRUSTS.—For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts, including the application of subpart D, shall be determined in accordance with regulations prescribed by the Secretary or his delegate.

§ 1.663(c)-1 SEPARATE SHARES TREATED AS SEPARATE TRUSTS; IN GENERAL.—(a) If a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts. In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust instrument creates not one but several separate trusts, as opposed to separate shares in the same trust within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts for purposes of—

(1) The filing of returns and payment of tax,

(2) The exclusion of dividends under section 116,

(3) The deduction of personal exemption under section 642(b), and

(4) The allowance to beneficiaries succeeding to the trust property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust under section 642(h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust, and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment.

§ 1.663(c)-2 COMPUTATION OF DISTRIBUTABLE NET INCOME.—The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust. Accordingly, any deduction or any loss which is applicable solely to one separate share of the trust is not available to any other share of the same trust.

§ 1.663(c)-3 APPLICABILITY OF SEPARATE SHARE RULE.—(a) The applicability of the separate share rule provided by section 663(c) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to—

(1) Distribute, apportion, or accumulate income, or

(2) Distribute corpus

to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries

may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) The separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or outright remainder to B. In such a case, in the taxable year of a trust in which a beneficiary dies items of income and deduction properly allocable under trust accounting principles to the period before a beneficiary's death are attributed to one share, and those allocable to the period after the beneficiary's death are attributed to the other share. Separate share treatment is not available to a succeeding interest, however, with respect to distributions which would otherwise be deemed distributed in a taxable year of the earlier interest under the throwback provisions of subpart D (sections 665 through 668). The application of this paragraph may be illustrated by the following example:

Example. A trust instrument directs that the income of a trust is to be paid to A for her life. After her death income may be distributed to B or accumulated. A dies on June 1, 1956. The trust keeps its books on the basis of the calendar year. The trust instrument permits invasions of corpus for the benefit of A and B, and an invasion of corpus was in fact made for A's benefit in 1956. In determining the distributable net income of the trust for the purpose of determining the amounts includible in A's income, income and deductions properly allocable to the period before A's death are treated as income and deductions of a separate share, and for that purpose no account is taken of income and deductions allocable to the period after A's death.

(f) Separate share treatment is not applicable to an estate.

§ 1.663(c)-4 Example.—Section 663(c) may be illustrated by the following example:

Example. (a) A single trust was created in 1940 for the benefit of A, B, and C, who were aged 6, 4, and 2, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income is to

be accumulated until he becomes 21 years of age. When a beneficiary reaches the age of 21, his share of the income may thereafter be either accumulated or distributed to him in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of his share of the trust estate, and the trust instrument requires that the beneficiary's right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, his share of the trust estate shall be paid over to him. The interest in the trust estate of any beneficiary dying without issue and before he has attained the age of 35 is to be equally divided between the other beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

(b) No distributions of income or corpus were made by the trustee prior to 1955, although A became 21 years of age on June 30, 1954. During the taxable year 1955, the trust has income from royalties of $20,000 and expenses of $5,000. The trustee in his discretion distributes $12,000 to A. Both A and the trust report on the calendar year basis.

(c) The trust qualifies for the separate share treatment under section 663(c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A's gross income under section 662.

(d) The distributable net income of each share of the trust is $5,000 ($6,667 less $1,667). Since the amount ($12,000) distributed to A during 1955 exceeds the distributable net income of $5,000 allocated to his share, the trust is deemed to have distributed to him $5,000 of 1955 income and $7,000 of amounts other than 1955 income. Accordingly, the trust is allowed a deduction of $5,000 under section 661. The taxable income of the trust for 1955 is $9,900, computed as follows:

Royalties		$20,000
Deductions:		
Expenses	$5,000	
Distribution to A	5,000	
Personal exemption	100	
		10,100
Taxable income		$9,900

(e) In accordance with section 662, A must include in his gross income for 1955 an amount equal to the portion ($5,000) of the distributable net income of the trust allocated to his share. Also, the excess distribution of $7,000 made by the trust is subject to the throwback provisions of section 665 through 668 and the regulations thereunder.

Treatment of Excess Distributions by Trusts

§ 1.665–1 Excess Distributions by Trusts; Scope of Subpart D.—Sections 665 through 668 (subpart D) are designed generally to prevent a shift of tax burden to a trust from a beneficiary or beneficiaries. To accomplish this, subpart D provides special rules for treatment of amounts paid, credited, or required to be distributed by a complex

trust (subject to sections 661 through 663 (subpart C)) in any year in excess of distributable net income for that year. Such an excess distribution is defined as an accumulation distribution, subject to the limitations in section 665(b). An accumulation distribution is "thrown back" to each of the five preceding years in inverse order. That is, it will be taxed to the beneficiaries of the trust in the year the distribution is made or required, but, in general, only to the extent of the distributable net income of those years which was not in fact distributed. However, the resulting tax will not be greater than the aggregate of the taxes that would have been attributable to the amounts thrown back to previous years had they been included in gross income of the beneficiaries in those years. To prevent double taxation, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess thrown back. Sections 665 through 668 (subpart D) do not apply to any estate.

§ 1.665(a) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; DEFINITION OF UNDISTRIBUTED NET INCOME.

SEC. 665. DEFINITIONS APPLICABLE TO SUBPART D.

(a) UNDISTRIBUTED NET INCOME.—For purposes of this subpart, the term "undistributed net income" for any taxable year means the amount by which distributable net income of the trust for such taxable year exceeds the sum of—

(1) the amounts for such taxable year specified in paragraphs (1) and (2) of section 661(a); and

(2) the amount of taxes imposed on the trust.

§ 1.665(a)-1 UNDISTRIBUTED NET INCOME.—(a) The term "undistributed net income" means for any taxable year the distributable net income of the trust for that year as determined under section 643(a), less—

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), *and*

(2) The amount of taxes imposed on the trust, as defined in § 1.665(c)-1.

The application of the rule in this paragraph to the first year of a trust in which income is accumulated may be illustrated by the following example:

Example. Assume that under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1954 the trust had distributable net income of $30,100 derived from royalties and the trustee made distribution of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,640 is paid. The undistributed net income of the trust as of the close of the taxable year 1954 is $7,460 computed as follows:

Distributable net income		$30,100
Less:		
Income currently distributable to A	$10,000	
Other amounts distributed to A	10,000	
Taxes imposed on the trust (see § 1.665(c)-1)	2,640	
		22,640
Undistributed net income		$7,460

See also paragraphs (e)(1) and (f)(1) of § 1.668(b)-2 for additional illustrations of the application of the rule in this paragraph to the first year of a trust in which income is accumulated.

(b) However, the undistributed net income for any year to which an accumulation distribution for a later year may be thrown back may be reduced by accumulation distributions in intervening years and also by any taxes imposed on the trust which are deemed to be distributed under section 666 by reason of the accumulation distributions. On the other hand, undistributed net income for any year will not be reduced by any distributions in an intervening year which are excluded from the definition of an accumulation distribution under section 665(b), or which are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (f)(5) of § 1.668(b)-2 for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

§ 1.665(b) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; DEFINITION OF ACCUMULATION DISTRIBUTION.

SEC. 665. DEFINITIONS APPLICABLE TO SUBPART D. * * *

(b) ACCUMULATION DISTRIBUTION.—For purposes of this subpart, the term "accumulation distribution" for any taxable year of the trust means the amount (if in excess of $2,000) by which the amounts specified in paragraph (2) of section 661(a) for such taxable year exceed distributable net income reduced by the amounts specified in paragraph (1) of section 661(a). For purposes of this subsection, the amount specified in paragraph (2) of section 661(a) shall be determined without regard to section 666 and shall not include—

(1) amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21;

(2) amounts properly paid or credited to a beneficiary to meet the emergency needs of such beneficiary;

(3) amounts properly paid or credited to a beneficiary upon such beneficiary's attaining a specified age or ages if—

(A) the total number of such distributions cannot exceed 4 with respect to such beneficiary,

(B) the period between each such distribution to such beneficiary is 4 years or more, and

(C) as of January 1, 1954, such distributions are required by the specific terms of the governing instrument; and

(4) amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution is made more than 9 years after the date of the last transfer to such trust.

§ 1.665(b)-1 ACCUMULATION DISTRIBUTION; IN GENERAL.—(a) Subject to the limitations set forth in § 1.665(b)-2 the term "accumulation distribution" for any taxable year means an amount (if in excess of $2,000) by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy

any person's legal obligation as that term is used in § 1.662(a)-4.) If the distribution as so computed is $2,000 or less, it is not an accumulation distribution within the meaning of sections 665 through 668 (subpart D). If the distribution exceeds $2,000, then the full amount is an accumulation distribution for the purposes of subpart D.

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, the provisions of sections 665 through 668 (subpart D) will not apply unless there is undistributed net income in at least one of the five preceding taxable years. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples (it is assumed in each case that the exclusions provided in § 1.665(b)-2 do not apply):

Example (1). A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1956, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		$10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		$5,000

Example (2). Under the terms of the trust instruments, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and, in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))		15,000
Other amounts distributed (section 661(a)(2))		$5,000
Distributable net income	$13,000	
Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		$5,000

Example (*3*). Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution	$20,000
Less: Income required to be distributed currently	0
Other amounts distributed (section 661(a)(2))	$20,000
Distributable net income	17,000
Accumulation distribution	$3,000

(d) There are not taken into account, in computing the accumulation distribution for any taxable year, any amounts deemed distributed in that year because of an accumulation distribution in a later year.

§ 1.665(b)-2 EXCLUSIONS FROM ACCUMULATION DISTRIBUTIONS.—(a) Certain amounts paid, credited, or required to be distributed to a beneficiary are excluded under section 665(b) in determining whether there is an accumulation distribution for the purposes of sections 665 through 668 (subpart D). These exclusions are solely for the purpose of determining the amount allocable to preceding years under section 666 and in no way affect the determination under sections 661 through 663 (subpart C) of the beneficiary's tax liability for the year of distribution. Further, amounts excluded from accumulation distributions do not reduce the amount of undistributed net income for the 5 years preceding the year of distribution.

(b) The amounts excluded from the computation of an accumulation distribution are discussed in the following subparagraphs:

(1) *Distributions from accumulations while a beneficiary is under 21.*—(i) The first exception to the definition of an accumulation distribution is for amounts paid, credited, or required to be distributed to a beneficiary who was under 21 years of age or unborn when it was accumulated. A distribution is to be considered as so paid, credited, or required to be distributed to the extent, and only to the extent, that there is no undistributed net income for taxable years preceding the year of distribution other than undistributed net income accumulated while the beneficiary was under 21. If a distribution can be made from income accumulated either before or after a beneficiary reaches 21, it will be considered as made from the most recently accumulated income, and it will be so considered even though the governing instrument directs that distributions be charged first against the earliest accumulations.

(ii) As was indicated in paragraph (a) of this section, a distribution of an amount excepted from the definition of an accumulation distribution will not reduce undistributed net income for the purpose of determining the effect of a future accumulation distribution. Thus, a distribution to a beneficiary of income accumulated before he reached 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. However,

all future distributions to the same beneficiary, or to another beneficiary to whom a distribution would be excepted under the provisions of this subparagraph, would be excepted from the definition of an accumulation distribution to the extent that they could not be paid, credited or required to be distributed from other accumulated income.

(iii) The following examples illustrate the application of the foregoing rules of this subparagraph (in each of these examples it is assumed that the exceptions in section 665(b)(2), (3), and (4) do not apply):

(*a*) Income is to be accumulated until A reaches 21 when the corpus and accumulated income are to be distributed to him. The distribution is not an accumulation distribution.

(*b*) Income is to be accumulated until A is 21, when it is to be distributed to him but the corpus is to remain in trust. A distribution of the accumulated income to A when he reaches 21 is not an accumulation distribution.

(*c*) Income is to be accumulated and added to corpus until A reaches 21, when he is to receive one-third of the corpus (including accumulations). Thereafter all the income is to be paid to A until he is 23 when the remaining corpus (including accumulations) is to be paid to him. If A dies under that age any undistributed portion is to be paid to B. Distributions to A at 21 and 23 out of accumulations are not accumulation distributions even though they include accumulated income. However, if A died at the age of 22, when B was 23, a distribution to B would be an accumulation distribution to the extent of income accumulations since B reached 21, and the amount of undistributed net income includible in the distribution will not be reduced by the previous distribution to A.

(*d*) Income is to be accumulated and added to corpus until A is 21. After he is 21, he is entitled to all the income and, in addition, to distributions of corpus in the discretion of the trustee. When he reaches 25 he is entitled to the corpus. Distributions to A are not accumulation distributions, whether they are discretionary or upon termination of the trust.

(*e*) The facts are the same as in the preceding example, except that income is to be accumulated until A is 23. Distributions to A are accumulation distributions to the extent of income accumulated after A reached 21.

(*f*) Income may be distributed among a testator's children or accumulated and added to corpus until the youngest child is 21, when the corpus is to be distributed to the testator's then living descendants. Upon termination of the trust, the corpus is distributed to A, age 21; B, age 23; and C, the child of a deceased child, age 3. The distributions to A and C are not accumulation distributions. The distribution to B is an accumulation distribution to the extent of income accumulated after he reaches 21. (If the terms of the trust were such that it was subject to the separate share treatment under section 663(c), the distribution to B would be an accumulation distribution only to the extent of income accumulated for B's separate share since he reached 21.)

§ 1.665(b)–2(b)

(*g*) Income may be distributed to A or accumulated and added to corpus during A's life. Upon the death of A the corpus is to be distributed to B. B is 23 at A's death. The distribution is an accumulation distribution to the extent of income accumulated since B reached 21.

(2) *Emergency distributions.*—The second exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary to meet his emergency needs. Whether or not a distribution falls within this exclusion depends upon the facts and circumstances causing the distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify for the exclusion. However, the beneficiary must be in actual need of the distribution and the fact that he had other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. Ordinary distributions for the support, maintenance, or education of the beneficiary would not qualify for the exclusion.

(3) *Certain distributions at specified ages.*—The third exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary upon the beneficiary's attaining a specified age or ages, *provided*, (i) the total number of such distributions with respect to that beneficiary cannot exceed 4; (ii) the period between each such distribution is 4 years or more; *and* (iii) on January 1, 1954, such distributions were required by the specific terms of the governing instrument. Any discretionary invasion of corpus at other times is not excluded under this subparagraph, but does not affect the status of distributions that would otherwise be excluded. If more than four distributions are required to be made to a particular beneficiary at specified ages if he survives to receive them, none of the distributions will be excluded, even though the beneficiary dies before he receives more than four. On the other hand, a direction to make additional distributions to a remainderman will not affect the status of distributions required to be made to the primary beneficiary. For example, a trust agreement provided on January 1, 1954, that when A reached age 25 he would receive one-eighth of the corpus and accumulated income, as then constituted, and similar distributions at ages 30, 35, and 40. It also provided for similar distributions to B after A's death, and for additional discretionary distributions to both A and B. Required distributions to both A and B are excluded, regardless of whether discretionary distributions are made, but discretionary distributions are not excluded. On the other hand, if an additional distribution to A was directed when he reached 45, no distributions to him would be excluded, regardless of when he died.

(4) *Certain final distributions.*—(i) The last exception to the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary as a final distribution of a trust if the final distribution is made more than 9 years after the date of the last transfer to such trust.

(ii) The term "last transfer to such trust" includes only transfers, whether by the original grantor or by a third person, made with a

donative intent. A transfer arising out of a property right held by the trust is excluded, such as a transfer by a debtor in satisfaction of his indebtedness, or a distribution in liquidation or reorganization of a corporation. If the terms of two or more trusts include cross-remainders on the deaths of life beneficiaries, the donative transfers occurred at the time the trusts were created. The addition of the corpus of one trust to that of another when a remainder falls in is therefore not a new transfer within the meaning of section 665(b)(4).

(iii) For example, under the terms of a trust created July 1, 1950, with an original corpus of $100,000, by H for the benefit of his wife, W, the income of the trust is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including all accumulated income, are to be distributed to W. No transfers were made by H or other persons to the trust after it was created. Both the trust and W file returns on the calendar year basis. In accordance with its terms, the trust terminated on June 30, 1960, and on August 1, 1960, the trustee made a final distribution of the assets of the trust to W, consisting of investments derived from $100,000 of donated principal, accumulated income of $30,000 attributable to the period July 1, 1950, through December 31, 1959, and income of $3,000 attributable to the period the trust was in existence during 1960. Subpart D is inapplicable to the $3,000 of income of the trust for 1960 since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in sections 661 through 663 (subpart C). However, the balance of the distribution will qualify as an exclusion from the provisions of sections 665 through 668 (subpart D).

§ 1.665(b)-3 EXCLUSIONS UNDER SECTION 663(a)(1).—Sections 665 through 668 (subpart D) have no application to an amount which qualifies as an exclusion under section 663(a)(1), relating to gifts, bequests, etc.

§ 1.665(c) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; DEFINITION OF TAXES IMPOSED ON THE TRUST.

SEC. 665 DEFINITIONS APPLICABLE TO SUBPART D. * * *

(c) TAXES IMPOSED ON THE TRUST.—For purposes of this subpart, the term "taxes imposed on the trust" means the amount of the taxes which are imposed for any taxable year on the trust under this chapter (without regard to this subpart) and which, under regulations prescribed by the Secretary or his delegate, are properly allocable to the undistributed portion of the distributable net income. The amount determined in the preceding sentence shall be reduced by any amount of such taxes allowed, under sections 667 and 668, as a credit to any beneficiary on account of any accumulation distribution determined for any taxable year.

§ 1.665(c)-1 TAXES IMPOSED ON THE TRUST.—(a) For the purpose of sections 665 through 668 (subpart D), the term "taxes imposed on the trust" means (for any taxable year) the amount of Federal income taxes which are properly allocable to the undistributed portion of the distributable net income. This amount is the difference between the total taxes of the trust for the year and the amount which would have been paid by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of sections

665 through 668 (subpart D), there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includible in distributable net income, such as capital gains allocable to corpus. The rule stated in this paragraph may be illustrated by the following example:

Example. (1) Under the terms of a trust, which reports on the calendar year basis, the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1954, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribuiton of $10,000 to A. The taxes imposed on the trust for the purposes of this subpart are $2,713, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2.000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gains		10,000
Gross income		$30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		$12,900
Total income taxes		$3,787

(3) The amount of taxes which would have been paid by the trust, had all of the distributable net income ($18,000) of the trust been distributed to A, is $1,074, computed as follows:

Taxable income of the trust	$12,000
Less: Undistributed portion of distributable net income ($18,000—$10,000)	8,000
Balance of taxable income	$4,900
Income taxes on $4,900	$1,074

(4) The amount of taxes imposed on the trust as defined in this paragraph is $2,713, computed as follows:

Total taxes	$3,787
Taxes which would have been paid by the trust had all of the distributable net income been distributed	1,074
Taxes imposed on the trust as defined in this paragraph	$2,713

(b) If in any subsequent year an accumulation distribution is made by the trust which results in a throwback to the taxable year, the taxes of the taxable year allocable to the undistributed portion of distributable net income (the taxes imposed on the trust), after the close of the subsequent year, are the taxes prescribed in paragraph (a) of this section reduced by the taxes of the taxable year allowed as credits to beneficiaries on account of amounts deemed distributed on the last day of the taxable year under section 666. See paragraph

(f) (4) of § 1.668(b)-2 for an illustration of the application of this paragraph.

§ 1.665(d) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; DEFINITION OF PRECEDING TAXABLE YEAR.

SEC. 665. DEFINITIONS APPLICABLE TO SUBPART D. * * *

(d) PRECEDING TAXABLE YEAR.—For purposes of this subpart, the term "preceding taxable year" does not include any taxable year of the trust to which this part does not apply. In the case of a preceding taxable year with respect to which a trust qualifies (without regard to this subpart) under the provisions of subpart B, for purposes of the application of this subpart to such trust for such taxable year, such trust shall, in accordance with regulations prescribed by the Secretary or his delegate, be treated as a trust to which subpart C applies.

§ 1.665(d)-1 PRECEDING TAXABLE YEAR.—(a) *Definition.*—For purposes of sections 665 through 668 (subpart D), the term "preceding taxable year" does not include any taxable year to which part I of subchapter J of chapter 1 of the Internal Revenue Code of 1954 does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of sections 665 through 668 (subpart D) may not, in general, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a trust (reporting on the calendar year basis) makes a distribution during the calendar year 1955 of income accumulated during prior years and the distribution exceeds the distributable net income of 1955, the excess distribution may be allocated under sections 665 through 668 (subpart D) to 1954, but it may not be allocated to 1953 and preceding years, since the Internal Revenue Code of 1939 applies to those years.

(b) *Simple trusts subject to sections 665 through 668 (subpart D).*—An accumulation distribution may be properly allocated to a preceding taxable year in which the trust qualified as a simple trust (that is, qualified for treatment under sections 651 and 652 (subpart B)). In such event, the trust is treated for such preceding taxable year in all respects as if it were a trust to which sections 661 through 663 (subpart C) apply. An example of such a circumstance would be in the case of a trust (required under the trust instrument to distribute all of its income currently) which received in the preceding taxable year extraordinary dividends or taxable stock dividends which the trustee in good faith allocated to corpus, but which are subsequently determined to be currently distributable to the beneficiary. See section 643(a) (4) and § 1.643(a)-4. The trust would qualify for treatment under sections 661 through 663 (subpart C) for the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and would be treated as other amounts properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, the distribution would qualify as an accumulation distribution for the purposes of sections 665 through 668 (subpart D) if in excess of $2,000 and not excepted under section 665(b) and the regulations thereunder. For the purposes only of sections 665 through 668 (subpart D), the trust would be treated as subject to the provisions of sections 661 through 663 (subpart C) for the preceding taxable year in which the extraordinary or taxable stock dividends were received,

and, in computing undistributed net income for such preceding year, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in the later year were made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

§ 1.665(d)–2 APPLICATION OF SEPARATE SHARE RULE.—In trusts to which the separate share rule of section 663(c) is applicable for any taxable year, sections 665 through 668 (subpart D) are applied as if each share were a separate trust. Thus, "undistributed net income" and the amount of an "accumulation distribution" are computed separately for each share. The "taxes imposed on the trust" are allocated as follows:

(a) There is first allocated to each separate share that portion of the "taxes imposed on the trust," computed before the allowance of credits under section 642(a), which bears the same relation to the total that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(1) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a)(5), (6), and (7); and

(2) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(b) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the "taxes imposed on the trust" which bear the same relation to the total that the items of income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust. The amount of taxes imposed on the trust allocable to a separate share as so determined is then reduced by the amount of the taxes allowed under sections 667 and 668 as a credit to a beneficiary of the separate share on account of any accumulation distribution determined for any taxable year intervening between the year for which the determination is made and the year of an accumulation distribution with respect to which the determination is made. See paragraph (b) of § 1.665(c)–1.

§ 1.666(a) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; ALLOCATION OF ACCUMULATION DISTRIBUTION.

SEC. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO 5 PRECEDING YEARS.

(a) AMOUNT ALLOCATED.—In the case of a trust which for a taxable year beginning after December 31, 1953, is subject to subpart C, the amount of the accumulation distribution of such trust for such taxable year shall be deemed to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of each of the 5 preceding taxable years to the

extent that such amount exceeds the total of any undistributed net incomes for any taxable years intervening between the taxable year with respect to which the accumulation distribution is determined and such preceding taxable year. The amount deemed to be distributed in any such preceding taxable year under the preceding sentence shall not exceed the undistributed net income of such preceding taxable year. For purposes of this subsection, undistributed net income for each of such 5 preceding taxable years shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

§ 1.666(a)-1 AMOUNT ALLOCATED.—(a) If a trust makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's taxable income for that year to the extent of the undistributed net income of the trust for the preceding 5 years. It is therefore necessary to determine the extent to which there is undistributed net income for the preceding 5 years. For this purpose, an accumulation distribution made in any taxable year is allocated to each of the 5 preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(b) If, before the application of the provisions of sections 665 through 668 (subpart D) to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1960 and the trust had no undistributed net income for the taxable year 1959, then no portion of the 1960 accumulation distribution is deemed distributed on the last day of 1959. For purposes of subpart D, the term "5 preceding taxable years" includes only the 5 taxable years immediately preceding the taxable year in which the accumulation distribution is made and which are subject to part I of subchapter J of chapter 1 of the Internal Revenue Code of 1954, even though the trust has no undistributed net income during one or more of those years.

(c) Paragraphs (a) and (b) may be illustrated by the following example:

Example. In 1959, a trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1958, the trust had $7,000 of undistributed net income; in 1957, none; in 1956, $12,000; in 1955, $4,000; in 1954, $4,000. The accumulation distribution will be deemed distributed $7,000 in 1958, none in 1957, $12,000 in 1956, $4,000 in 1955, and $2,000 in 1954.

(d) For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is computed without regard to the accumulation distribution of the taxable year or of taxable years following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. Accordingly, if a trust has undistributed net income for the taxable year 1954 and makes an accumulation distribution during the taxable year 1955, the undistributed net income for 1954 is computed without

regard to the accumulation distribution for 1955 or any subsequent year. If the trust makes a further accumulation distribution for 1956, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1956 or subsequent years; but in determining the undistributed net income for 1954 for purposes of the 1956 accumulation distribution the accumulation distribution for 1955 will be taken into account.

§ 1.666(b) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; TOTAL TAXES DEEMED DISTRIBUTED.

SEC. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO 5 PRECEDING YEARS. * * *

(b) TOTAL TAXES DEEMED DISTRIBUTED.—If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year, and such portion of such accumulation distribution is not less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661(a). Such additional amount shall be equal to the taxes imposed on the trust for such preceding taxable year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to such accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

§ 1.666(b)–1 TOTAL TAXES DEEMED DISTRIBUTED.—(a) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the "taxes imposed on the trust" (as defined in § 1.665(c)–1) for such preceding taxable year is likewise deemed distributed under section 661(a)(2). For example, a trust has taxable income of $11,032 (not including any capital gains) and undistributed net income of $8,000 for the taxable year 1954. The taxes imposed on the trust are $3,032. During the taxable year 1955, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under § 1.666(a)–1 to have been distributed on the last day of 1954. The taxes imposed on the trust for 1954 of $3,032 are also deemed to have been distributed on the last day of 1954 since the 1955 accumulation distribution is not less than the 1954 undistributed net income. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1954 because of the accumulation distribution of $8,000 made in 1955.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following such taxable year. However, any accumulation distribution of taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)–1 and paragraphs (f)(5) and (g)(1) of § 1.668(b)–2.

§ 1.666(c) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; PRO RATA PORTION OF TAXES DEEMED DISTRIBUTED.

SEC. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO 5 PRECEDING YEARS. * * *

(c) PRO RATA PORTION OF TAXES DEEMED DISTRIBUTED.—If any portion of an accumulation distribution for any taxable year is deemed under subsection (a) to be an amount within the meaning of paragraph (2) of section 661(a) distributed on the last day of any preceding taxable year and such portion of the accumulation distribution is less than the undistributed net income for such preceding taxable year, the trust shall be deemed to have distributed on the last day of such preceding taxable year an additional amount within the meaning of paragraph (2) of section 661(a). Such additional amount shall be equal to the taxes imposed on the trust for such taxable year multiplied by the ratio of the portion of the accumulation distribution to the undistributed net income of the trust for such year. For purposes of this subsection, the undistributed net income and the taxes imposed on the trust for such preceding taxable year shall be computed without regard to the accumulation distribution and without regard to any accumulation distribution determined for any succeeding taxable year.

§ 1.666(c)-1 PRO RATA PORTION OF TAXES DEEMED DISTRIBUTED.—(a) If an accumulation distribution is deemed under § 1.666(a)-1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust, as defined in § 1.665(c)-1, for such preceding taxable year, multiplied by the fraction of which the numerator is the amount of the accumulation distribution and the denominator is the undistributed net income for such preceding taxable year. See paragraph (b) of example (1) and paragraphs (c) and (f) of example (2) in § 1.666(c)-2, and paragraph (f)(2) of § 1.668(b)-2 for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666 (a)-1, paragraph (c) of example (1) and paragraphs (e) and (h) of example (2) in § 1.666(c)-2 and paragraph (f)(5)(iii) of § 1.668(b)-2.

§ 1.666(c)-2 ILLUSTRATION OF THE PROVISIONS OF SECTION 666.—The application of the provisions of §§ 1.666(a)-1, 1.666(b)-1, and 1.666(c)-1 may be illustrated by the following examples:

Example (1).—(a) A trust makes accumulation distributions as follows:

1959	$7,000
1960	25,000

For 1954 through 1958, the undistributed portion of distributable net income, taxes imposed on the trust, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust	Undistributed net income
1958	$12,100	$3,400	$8,700
1957	16,100	5,200	10,900
1956	6,100	1,360	4,740
1955	None	None	None
1954	10,100	2,640	7,460

(b) Since the entire amount of the accumulation distribution for 1959 ($7,000), determined without regard to the accumulation distribution for 1960, is less than the undistributed net income for 1958 ($8,700), an additional amount of $2,736 (7,000/8,700×$3,400) is likewise deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1960, the undistributed net income for 1958 will take into account the accumulation distribution for 1959, and the additional amount of taxes imposed on the trust for 1958 deemed distributed. The undistributed net income for 1958 will then be $1,906; and the taxes imposed on the trust for 1958 will then be $458, determined as follows:

Undistributed portion of distributable net income as of the close of 1958		$12,100
Less:		
Accumulation distribution (1959)	$7,000	
Taxes deemed distributed under section 666(c) (7,000/8,700×$3,400)	2,736	
		9,736
Balance (undistributed portion of distributable net income as of the close of 1959)		$2,364
Less: Personal exemption		100
Balance		$2,264
Taxes imposed on the trust (income taxes on $2,264)		$458
Undistributed portion of distributable net income as of the close of 1959		$2,364
Less: Income taxes attributable thereto		458
Undistributed net income for 1958 as of the close of 1959		$1,906

(d) The accumulation distribution of $25,000 for 1960 is deemed to have been made on the last day of the of the 5 preceding taxable years of the trust to the extent of $17,546, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $7,018, the total taxes imposed on the trust for such years, is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1959	None	None
1958	$1,906	$458
1957	10,900	5,200
1956	4,740	1,360
1955	None	None

(e) No portion of the 1960 accumulation distribution is deemed made on the last day of 1954 because, as to 1960, 1954 is the sixth preceding taxable year.

Example (2). (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1954 was accumulated. The distributable net income of the trust for the taxable year 1954 is $20,100 and the income taxes paid by the trust for 1954 with respect to its distributable net income are $7,260. All of the income for 1955 and 1956 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $6,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1954, is $12,840, computed as follows:

Distributable net income	$20, 100
Less: Taxes imposed on the trust	7, 260
Undistributed net income as of the close of 1954	$12, 840

(c) The accumulation distribution of $6,420 made during the taxable year 1955 is deemed under section 666(a) to have been made on December 31, 1954. Since this accumulation distribution is less than the 1954 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1954 is also deemed under section 666(c) to have been distributed on December 31, 1954. The total amount deemed to have been distributed to X on December 31, 1954, is $10,050, computed as follows:

Accumulation distribution	$6, 420
Taxes deemed distributed (6,420/12,840×$7,260)	3, 630
Total	$10, 050

(d) After the application of the provisions of sections 665 through 668 (subpart D) to the accumulation distribution of 1955, the undistributed portion of the distributable net income of the trust for 1954, is $10,050, and the taxes imposed with respect thereto are $2,623, computed as follows:

Distributable net income as of the close of 1954	$20, 100
Less: 1955 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (c))	10, 050
Undistributed portion of the 1954 distributable net income adjusted as of the close of 1955	$10, 050
Less: Personal exemption	100
Balance	$9, 950
Income taxes on $9,950	$2, 623

(e) The undistributed net income of the trust for the taxable year 1954, as adjusted to give effect to the 1955 accumulation distribution, is $7,427, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10, 050
Less: Income taxes applicable thereto	2, 623
Undistributed net income determined as of the close of 1955	$7, 427

(f) Inasmuch as all of the income of the trust for the taxable year 1955 was distributed to X, the trust had no undistributed net income for that year. Accordingly, the accumulation distribution of $6,420 made during the taxable year 1956 is, under section 666(a), deemed a distribution to X on December 31, 1954, within the meaning of

section 661(a)(2). Since this accumulation distribution is less than the 1954 adjusted undistributed net income of $7,427, the trust is deemed under section 666(c) also to have distributed on December 31, 1954, a portion of the taxes imposed on the trust for 1954. The total amount deemed to be distributed on December 31. 1954, with respect to the accumulation distribution made in 1956, is $8,687, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/7,427×$2,623)	2,267
Total	$8,687

(g) After the application of the provisions of sections 665 through 668 (subpart D) to the accumulation distribution of 1956, the undistributed portion of the distributable net income of the trust for 1954, is $1,363, and the taxes imposed on the trust with respect thereto are $253, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: 1956 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (f))	8,687
Undistributed portion of distributable net income as of the close of 1956	$1,363
Less: Personal exemption	100
Balance	$1,263
Income taxes on $1,263	$253

(h) The undistributed net income of the trust for the taxable year 1954, determined as of the close of the taxable year 1956, is $1,110 ($1,363 less $253).

§ 1.667 Statutory Provisions; Excess Distributions by Trusts; Denial of Refund to Trusts.

SEC. 667. DENIAL OF REFUND TO TRUSTS.

The amount of taxes imposed on the trust under this chapter, which would not have been payable by the trust for any preceding taxable year had the trust in fact made distributions at the times and in the amounts deemed under section 666, shall not be refunded or credited to the trust, but shall be allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions. For purposes of the preceding sentence, the amount of taxes which may not be refunded or credited to the trust shall be an amount equal to the excess of (1) the taxes imposed on the trust for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over (2) the amount of taxes for such preceding taxable year imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of this subpart on account of the accumulation distribution determined for such taxable year.

§ 1.667–1 Denial of Refund to Trusts.—(a) If an amount is deemed under section 666 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of "taxes imposed on the trust," as defined in § 1.665(c)–1, which would not have been payable for the preceding taxable year had the trust in fact made such distribution on the last day of such year. However, such taxes are allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions in the

deduction has already been utilized in reducing the amount included in the beneficiary's income.

§ 1.668(a)-2 ALLOCATION AMONG BENEFICIARIES; IN GENERAL.—The portion of the total amount includible in gross income under § 1.668(a)-1 which is includible in the gross income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for the taxable year 1955 is $10,000. The trust had undistributed net income for the taxable year 1954 of $5,000, to which a tax of $1,100 was allocable. During the taxable year 1955, the trustee distributes $10,000 to A and $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B received one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1955, the trust is deemed to have made the following distributions:

Amount distributed out of 1955 income (distributable net income)	$10, 000
Accumulation distribution deemed distributed by the trust on the last day of 1954 under section 666(a)	5, 000
Taxes imposed on the trust deemed distributed under section 666(b)	1, 100

(c) A will include in his gross income for 1955 two-thirds of each item shown in paragraph (b). Thus, he will include in gross income $6,666.67 (10,000/15,000×$10,000) of the 1955 distributable net income of the trust as provided in section 662(a)(2), and $3,333.33 (10,000/15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000×$1,100) of the taxes imposed on the trust as provided in section 668(a).

(d) B will include in his gross income for 1955 one-third of each item shown in paragraph (b), computed in the manner shown in paragraph (c).

§ 1.668(a)-3 EXCLUDED AMOUNTS.—When a trust pays, credits, or is required to distribute to a beneficiary amounts which are excluded under section 665(b)(1), (2), (3), or (4) from the computation of an accumulation distribution, the amount includible under sections 665 through 668 (subpart D) in the gross income of the beneficiaries pursuant to § 1.668(a)-1 is first allocated to the beneficiaries as provided in § 1.668(a)-2 and, second, the amount allocable to the beneficiary receiving amounts which are excluded under section 665(b)(1), (2), (3), or (4) is reduced by the excluded amounts. This section may be illustrated by the following examples, in which it is assumed the trusts and beneficiaries report on the calendar year basis and the income of the trusts was derived entirely from taxable interest:

Example (1). (a) A trust in 1957 has income as defined in section 643(b) of $35,000 and expenses allocable to corpus of $5,000. Its distributable net income is, therefore, $30,000 ($35,000−$5,000). The undistributed net income of the trust and the taxes imposed on

the trust were $12,840 and $7,260, respectively, for each of the years 1956, 1955, and 1954. The terms of the trust instrument provide for the accumulation of income during the minority of beneficiaries A and B. However, the trustee may make discretionary distributions to either beneficiary after he becomes 21 years of age. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on January 1, 1957, and, as of that date, A was 25 years old. The trustee distributed $50,000 each to A and B during 1957.

(b) Since each beneficiary received one-half of the total amount distributed by the trust, each must include in gross income under section 662(a)(2) one-half ($15,000) of the distributable net income ($30,000) of the trust for 1957.

(c) The excess distribution of $35,000 ($50,000—$15,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in B's gross income under section 668(a). Nor is such amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income under section 668(a).

(d) The accumulation distribution of the trust is $35,000, computed as follows:

Total distribution by the trust		$100,000
Less:		
Distributable net income for 1957	$30,000	
Excess distribution to B	35,000	
		65,000
Accumulation distribution to A		$35,000

(e) The accumulation distribution of $35,000 will be allocated to the preceding taxable years 1956, 1955, and 1954, and the trust will be deemed to have made the following distributions to A on the last day of those years:

	1956	*1955*	*1954*	*Total*
Undistributed net income	$12,840	$12,840	$9,320	$35,000
Taxes imposed on the trust	7,260	7,260	5,270	19,790
Total	$20,100	$20,100	$14,590	$54,790

Thus, A will include $54,790 in his gross income for 1957 under section 668(a). A will, however, receive credit against his tax under section 668(b).

Example (2). (a) Under the terms of a trust the trustee may make discretionary distributions out of income to A during her life. The balance of the income is to be accumulated during the minority of her son, B, and is to be distributed to him when he becomes 21 years of age. Thereafter the trustee may also may discretionary payments of income to B. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on December 31, 1955. The distributable net income of the trust for 1955 is $30,000. It had undistributed net income of $12,840 for the preceding taxable year 1954 and the taxes imposed on the trust for such year were $7,260. The trustee distributed $15,000 to A during 1955 and on December 31, 1955, he distributed $60,000 to B, which represented income accumulated during his minority.

(b) Since B received four-fifths of the total amount ($75,000) distributed by the trust during 1955, he must include in his gross income under section 662(a)(2) four-fifths ($24,000) of the distributable net income ($30,000) of the trust for 1955. A will include in her gross income under section 662(a)(2) one-fifth ($6,000) of the distributable net income ($30,000) of the trust for 1955.

(c) The excess distribution of $36,000 ($60,000—$24,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in his gross income under section 668(a).

(d) The amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income for 1955 under section 668(a) is $9,000, computed as follows:

Total distribution by the trust		$75,000
Less:		
Distributable net income for 1955	$30,000	
Excess distribution to B	36,000	
		66,000
Amount treated as an accumulation distribution		$9,000

(e) Inasmuch as the amount of $9,000 is less than the total undistributed net income of the trust ($12,840) for the preceding taxable year 1954, a pro rata portion of the taxes imposed on the trust for that year are also deemed distributed by the trust. Thus, A will include $14,089 in her gross income for 1955 under section 668(a) computed as follows:

	1954
Accumulation distribution	$9,000
Taxes imposed on the trust (9,000/12,840×$7,260)	5,089
Total	$14,089

A will, however, receive credit against her tax under section 668(b).

§ 1.668(a)-4 Tax Attributable to Throwback.—(a) The tax attributable to amounts deemed distributed under section 666 is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made unless the taxable year of the beneficiary is different from that of the trust (see section 662(c) and the regulations thereunder). However, the tax cannot be greater than the aggregate of the taxes attributable to those amounts had they been included, in accordance with the provisions of section 662(a)(2) and (b), in the gross income of the beneficiary for the preceding taxable year or years in which they were deemed distributed. The tax liability of the beneficiary for the taxable year is computed in the following manner:

(1) First, compute the amount of tax for the taxable year attributable to the section 666 amounts which are included in the gross income of the beneficiary for the year. The tax attributable to those amounts is the difference between the tax for the taxable year computed with the inclusion of the section 666 amounts in gross income and the tax computed without including them in gross income.

(2) Next, compute the tax attributable to the section 666 amounts for each of the preceding taxable years as if they had been included

in gross income for those years. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding year computed with the inclusion of the section 666 amounts in gross income and the tax for such year computed without including them in gross income. The tax computation for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(3) The total tax for the taxable year is the tax for that year computed without including the section 666 amounts, *plus*—

(i) The amount of the tax for the taxable year attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph),

or

(ii) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (2) of this paragraph),

whichever is the smaller.

(b) The provisions of paragraph (a) of this section may be illustrated by the following example:

Example. (1) During the taxable year 1956, $10,000 is deemed distributed under section 666 to a beneficiary, of which $6,000 is deemed distributed by the trust on the last day of 1955 and $4,000 on the last day of 1954. The beneficiary had taxable income (after deductions) from other sources of $5,000 for 1956, $10,000 for 1955, and $10,000 for 1954. The beneficiary's tax liability for 1956 is $4,730 determined as follows:

Year 1956

Tax on $15,000 (taxable income including section 666 amounts)	$4, 730
Tax on $5,000 (taxable income excluding section 666 amounts)	1, 100
Tax attributable to section 666 amounts	$3, 630

Year 1955

Tax on $16,000 (taxable income including section 666 amounts)	$5, 200
Tax on $10,000 (taxable income excluding section 666 amounts)	2, 640
Tax attributable to section 666 amounts	$2, 560

Year 1954

Tax on $14,000 (taxable income including section 666 amounts)	$4, 260
Tax on $10,000 (taxable income excluding section 666 amounts)	2, 640
Tax attributable to section 666 amounts	$1, 620

(2) Inasmuch as the tax of $3,630 attributable to the section 666 amounts as computed at 1956 rates is less than the aggregate of the taxes of $4,180 ($2,560 plus $1,620) determined for the preceding taxable years, the amount of $3,630 is added to the tax ($1,100) computed for 1956 without including the section 666 amounts.

§ 1.668(a)–4(b)

§ 1.668(b) STATUTORY PROVISIONS; EXCESS DISTRIBUTIONS BY TRUSTS; TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING TAXABLE YEARS; CREDIT FOR TAXES PAID BY TRUST.

SEC. 668. TREATMENT OF AMOUNTS DEEMED DISTRIBUTED IN PRECEDING YEARS. * * *

(b) CREDIT FOR TAXES PAID BY TRUST.—The tax imposed on beneficiaries under this chapter shall be credited with a pro rata portion of the taxes imposed on the trust under this chapter for such preceding taxable year which would not have been payable by the trust for such preceding taxable year had the trust in fact made distributions to such beneficiaries at the times and in the amounts specified in section 666.

§ 1.668(b)-1 CREDIT FOR TAXES PAID BY THE TRUST.—(a) The taxes imposed on a complex trust for a taxable year which would not have been payable by the trust if amounts deemed under section 666 to have been distributed in the year had in fact been distributed in the year are not allowable as a refund to the trust but are allowable as a credit against the tax of the beneficiaries to whom the amounts described in section 666(a) are distributed.

(b) The credit to which a beneficiary is entitled under section 668(b) is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the gross income of the beneficiary. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary.

(c) The beneficiary is entitled to a portion of the credit described in paragraph (a) of this section in the ratio which the amount of the accumulation distribution to him bears to the accumulation distributions to all the beneficiaries.

§ 1.668(b)-2 ILLUSTRATION OF THE PROVISIONS OF SECTIONS 665 THROUGH 668.—The provisions of sections 665 through 668 (subpart D) may be illustrated by the following example:

Example. (a) *Facts.* (1) Under the terms of a trust instrument, one-half of the trust income is required to be distributed currently to beneficiary A. The trustee may in his discretion accumulate the balance of the income of the trust or he may make distributions to B out of income or corpus. The trust is to terminate upon the death of A and the corpus is to be distributed to B. Capital gains are allocable to corpus. All of the expenses of the trust are charges against income. The trust instrument provides for a reserve for depreciation, so that depreciation is deductible in computing distributable net income. The trust and both beneficiaries report on the calendar year basis. The trust had long-term capital gains of $20,000 for 1954, and $10,000 for 1955, which were allocated to corpus. The distributable net income of the trust as determined under section 643(a) for 1954, 1955, 1956, and 1957 is deemed to consist of the following items of income:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1954	$15,000	$20,000	$10,000	$5,000	$50,000
1955	10,000	15,000	10,000	5,000	40,000
1956	10,000	20,000	15,000	5,000	50,000
1957	10,000	15,000	15,000	5,000	45,000

(2) One-half ($7,500) of the dividends for 1954 was received by the trust on or before July 31, 1954, and the balance was received after that date.

(3) The following distributions were made by the trustee to A and B during the taxable years 1954 through 1957:

	A	B
1954	$25,000	None
1955	20,000	None
1956	25,000	$45,000
1957	22,500	29,550

(b) *Distributions to A.*—A is deemed to have received one-half of each item of income entering into the computation of distributable net income as shown in paragraph (a)(1) of this example. See § 1.662(a)–2 for rules for the treatment of currently distributable income in the hands of the beneficiary.

(c) *Tax liability of the trust.*—(1) *1954.*—(i) The tax liability of the trust for the taxable year 1954 is $13,451, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1))		$50,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		$44,950
Add: Capital gains (long-term)		20,000
Total		$64,950
Deductions:		
Distributions to A	$22,475	
Capital gain deduction	10,000	
Personal exemption	100	
		32,575
Taxable income		$32,375
Alternative tax		13,601
Dividend received credit		150
Tax liability		$13,451

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half of the dividends of the trust are deemed to be distributed to A, $25 of such distribution is deemed to be made from the dividend exclusion of $50, and the balance from dividends included in the gross income of the trust (that is, since the year 1954 is involved, $3,725 from dividends received on or before July 31, 1954, and $3,750 from dividends received after July 31, 1954).

§ 1.668(b)–2

The trust is entitled to a dividend received credit attributable to the dividends of $3,750 received after July 31, 1954, which were not distributed to any beneficiary during the taxable year.

(2) *1955.*—(i) The tax liability of the trust for the taxable year 1955 is $8,189, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1))		$40,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		$34,950
Add: Capital gains (long-term)		10,000
Total		$44,950
Deductions:		
Distributions to A	$17,475	
Capital gain deduction	5,000	
Personal exemption	100	
		22,575
Taxable income		$22,375
Alternative tax		8,388
Dividend received credit		199
Tax liability		$8,189

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half ($4,975) of the dividends of $9,950 ($10,000 less dividend exclusion of $50) included in the gross income of the trust is deemed distributed to A, the trust is entitled to a dividend received credit with respect to the dividends of $4,975 which were not distributed to any beneficiary during the taxable year.

(3) *1956 and 1957.*—The trust had no tax liability for the taxable years 1956 and 1957 since all of its income was distributed during such years.

(d) *Accumulation distributions.*—(1) Accumulation distributions of $20,000 and $7,050, as defined in section 665(b), were made to B during the years 1956 and 1957, respectively, computed as shown below:

	1956	1957
Distributable net income of the trust as computed under section 643(a)	$50,000	$45,000
Less: Income currently distributable to A	25,000	22,500
Balance of income	$25,000	$22,500
Other amounts distributed to B	45,000	29,550
Accumulation distributions to B	$20,000	$7,050

(2) B is deemed to have received one-half of each item of income entering into the computation of distributable net income (shown in paragraph (a)(1)) for the years 1956 and 1957.

(3) The accumulation distribution for 1956 must first be allocated to the preceding taxable years as provided in section 666. After the application of the provisions of sections 665 through 668 (subpart D) to the 1956 accumulation distribution and to the undistributed net

incomes of the preceding taxable years, a similar allocation must be made of the 1957 accumulation distribution.

(e) *Throwback of 1956 accumulation distribution to 1955.*—The accumulation distribution of $20,000 for 1956 must be allocated to the first preceding taxable year 1955, before allocation is made to the second preceding taxable year 1954.

(1) *1955 undistributed net income.*—(i) The undistributed net income of the trust for 1955, determined as of the close of 1955, is $12,885, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1))		$40,000
Less:		
Distributions to A	$20,000	
Taxes imposed on the trust	7,115	
		27,115
Undistributed net income as of the close of 1955		$12,885

(ii) The taxes imposed on the trust of $7,115 are that portion of the taxes paid by the trust for 1955 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below) and is determined as follows:

Taxable income (paragraph (c)(2)(i))			$22,375
Capital gains allocable to corpus		$10,000	
Less:			
Capital gain deduction	$5,000		
Personal exemption	100		
		5,100	
Portion of taxable income allocable to corpus			4,900
Balance			$17,475
Total taxes paid by the trust			$8,189
Taxes on income ($4,900) allocable to corpus			1,074
Taxes imposed on the trust (section 665(c))			$7,115

(iii) The amount of $1,074 is the taxes which the trust would have paid for 1955 had all of the distributable net income been distributed during the year.

(2) *Allocation of 1956 accumulation distribution to the preceding taxable year 1955.*—The portion of the 1956 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1955 (the first preceding taxable year) is $12,885, an amount equal to the undistributed net income for 1955. An additional amount equal to the taxes imposed on the trust ($7,115) is, under section 666(b), also deemed to be distributed to B on the last day of 1955. Thus, a total of $20,000 ($12,885 plus $7,115) is deemed to be distributed to B on December 31, 1955, by reason of the allocation of the 1956 accumulation distribution to the first preceding taxable year. See paragraph (h) of this example for the treatment of the amount of $20,000 in the hands of B.

(3) *Character of amounts deemed distributed.*—Inasmuch as one-half of the 1955 distributable net income of the trust as determined

under section 643(a) was currently distributable to A and the balance of such income is deemed under section 666 to be distributed to B on December 31, 1955, the distribution to B is deemed to consist of one-half of each item of income entering into the computation of the 1955 distributable net income; that is, dividends of $5,000, rents of $7,500, taxable interest of $5,000, and tax-exempt interest of $2,500.

(4) *Credit for taxes paid by the trust.*—The amount of the taxes for the year 1955 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b) is $7,115. See also paragraph (h)(3) of this example.

(5) *Effect of application of provisions of sections 665 through 668 (subpart D) to the year 1955.*—After the allocation of the 1956 accumulation distribution to the preceding taxable year 1955, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1955 are zero. The portion of the 1956 accumulation distribution which is unabsorbed by the 1955 undistributed net income is $7,115, determined as follows:

1956 accumulation distribution (paragraph (d)(1))	$20,000
Less: Amount allocable to 1955	12,885
Balance allocable to second preceding taxable year 1954	$7,115

(f) *Throwback of 1956 accumulation distribution to 1954.*—The unabsorbed portion of the 1956 accumulation distribution of $7,115 is allocable to the second preceding taxable year 1954 and is treated under section 666 as a distribution to B on the last day of such year.

(1) *1954 undistributed net income.*—(i) The undistributed net income of the trust for 1954, determined as of the close of 1954, is $14,155, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1))		$50,000
Less: Distributions to A	$25,000	
Taxes imposed on the trust	10,845	
		35,845
Undistributed net income as of the close of 1954		$14,155

(ii) The taxes imposed on the trust of $10,845 are that portion of the taxes paid by the trust for 1954 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below) and is determined as follows:

Taxable income (paragraph (c)(1)(i))			$32,375
Capital gains allocable to corpus		$20,000	
Less:			
Capital gain deduction	$10,000		
Personal exemption	100	10,100	
Portion of taxable income allocable to corpus			9,900
Balance			$22,475
Total taxes paid by the trust			$13,451
Taxes on income ($9,900) allocable to corpus			2,606
Taxes imposed on the trust (section 665(c))			$10,845

(iii) The amount of $2.606 is the taxes which the trust would have paid for 1954 had all of the distributable net income been distributed during that year.

(2) *Allocation of 1956 accumulation distribution to the second preceding taxable year 1954.*—Since the unabsorbed portion of the 1956 accumulation distribution of $7,115 is less than the 1954 undistributed net income of $14.155, the trust is deemed under section 666(c) to have also distributed an additional amount ($5,451) equal to a pro rata portion (7,115/14,155×$10,845) of the taxes imposed on the trust for 1954. Thus, a total of $12,566 ($7,115 plus $5.451) is deemed to be distributed to B on December 31, 1954, by reason of the throwback of the 1956 accumulation distribution. See paragraph (h) of this example for the treatment of the amount of $12,566 in the hands of B.

(3) *Character of amounts deemed distributed to B.*—The amount of $12,566 which, under section 666. is deemed to be distributed to B on December 31, 1954. is deemed to be composed of the following items of income of the trust: Dividends. $3,770 (15,000/50,000×$12,566); rents, $5.026 (20,000/50,000×$12.566); taxable interest, $2,513 (10,000/50,000×$12,566): and tax-exempt interest. $1,257 (5,000/50,000×$12.566). One-half of the dividends of $3,770 is considered as distributed from the dividends received by the trust on or before July 31. 1954, of which $13 (3,770/15,000×$50) is deemed distributed from the dividends excluded under section 116, and the other half as distributed from the dividends received after July 31, 1954. Thus, of the total of $12,566 deemed distributed to B, $11,296 is considered as made from income included in the gross income of the trust and $1,270 from nontaxable income of the trust.

(4) *Credit for taxes paid by the trust.*—The amount of the taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b). because of the allocation of the 1956 accumulation distribution to 1954, is $5,401, computed as follows:

Taxable income of the trust as of the close of 1954 (paragraph (c)(1))	$32,375
Less: Amount deemed distributed to B under section 666 from the taxable income of the trust	11,296
Taxable income adjusted as of the close of 1956	$21,079
Taxes on $21,079 (alternative tax)	$8,050
Taxes on income allocable to corpus (subparagraph (1)(ii) of this paragraph)	2,606
Taxes imposed on the trust determined as of the close of 1956	$5,444
Taxes imposed on the trust determined as of the close of 1954	$10,845
Taxes imposed on the trust determined as of the close of 1956	5,444
Amount of taxes allowed as a credit to B under section 668(b)	$5,401

(5) *Effect of application of provisions of sections 665 through 668 (subpart D) to the year 1954.*—(i) The undistributed portion

of the distributable net income of the trust for the year 1954, determined as of the close of 1956, is $12,434, computed as follows:

Distributable net income (section 643(a))		$50,000
Less:		
Amount currently distributable to A	$25,000	
Amount deemed distributed to B under section 666	12,566	
		37,566
Undistributed portion of distributable net income as of the close of 1956		$12,434

(ii) The amount of $12,434 is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243, determined as follows:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
Trust income	$15,000	$20,000	$10,000	$5,000	[1] $50,000
Distributions:					
To A	7,500	10,000	5,000	2,500	[2] 25,000
To B	3,770	5,026	2,513	1,257	[3] 12,566
Total	$11,270	$15,026	$7,513	$3,757	$37,566
Balance	$3,730	$4,974	$2,487	$1,243	$12,434

[1] See paragraph (a)(1). [2] See paragraph (b). [3] See paragraph (f)(3).

(iii) The undistributed net income of the trust for 1954, determined as of the close of 1956, is $6,990, computed as follows:

Undistributed portion of distributable net income as of the close of 1956	$12,434
Less: Taxes imposed on the trust determined as of the close of 1956 (subparagraph (4) of this paragraph)	5,444
Undistributed net income as of the close of 1956	$6,990

(g) *Throwback of 1957 accumulation distribution.*—Inasmuch as all of the income of the trust for the first preceding taxable year 1956 was distributed during such year and the trust had no undistributed net income for the second preceding taxable year 1955 after the application of sections 665 through 668 (subpart D) to the accumulation distribution made during 1956, the 1957 accumulation distribution of $7,050 is allocable to the third preceding taxable year 1954. See paragraph (d)(1) for computation of the accumulation distribution.

(1) *Allocation of 1957 accumulation distribution to the preceding taxable year 1954.*—The portion of the 1957 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1954 is $6,990, an amount equal to the undistributed net income of the trust for 1954, determined as of the close of 1956. An additional amount equal to the taxes imposed on the trust ($5,444), determined as of the close of 1956, is under section 666(b) also deemed to be distributed to B on the last day of 1954. See paragraph (f)(4) and (5) of this example. Thus, a total of $12,434 ($6,990 plus $5,444) is deemed to be distributed to B on December 31, 1954, by reason of the allocation of the 1957 accumulation distri-

bution to the taxable year 1954. See paragraph (j) of this example for the treatment of the amount of $12,434 in the hands of B.

(2) *Character of amounts deemed distributed.*—Inasmuch as the balance of the 1954 distributable net income of the trust is deemed under section 666 to be distributed to B on December 31, 1954, the distribution is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243. See paragraph (f)(5)(ii) of this example.

(3) *Credit for taxes paid by the trust.*—The amount of taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B under section 668(b) is $5,444, the amount of taxes imposed on the trust determined as of the close of 1956. See paragraph (f)(4) of this example.

(4) *Effect of application of provisions of sections 665 through 668 (subpart D) to the year 1954.*—After the allocation of the 1957 accumulation distribution to the preceding taxable year 1954, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1954 are zero. The balance of $60 ($7,050 less $6,990) of the 1957 accumulation distribution remaining after the allocation of the accumulation distribution to the year 1954, may not be allocated to the year 1953 since that year is not subject to the provisions of the Internal Revenue Code of 1954.

(h) *Determination of B's tax liability; taxable year 1956.*—(1) *Amount of trust income includible in gross income.*—(i) Of the amount of $45,000 distributed by the trust to B during the taxable year 1956, $25,000 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $20,000 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $12,885 plus taxes of $7,115 is deemed distributed to B on December 31, 1955, and $7,115 plus taxes of $5,451 on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1956, and these amounts are includible in B's gross income for 1956 to the extent that they would have been includible in his gross income under section 662(a)(2) and (b) for 1955 and 1954, respectively, had they been distributed on the last day of those years.

(ii) The amounts distributed to B out of trust income for the year 1956, and the amounts deemed distributed out of income for the preceding taxable years 1955 and 1954 have the following character for the purpose of determining the amount includible in B's gross income for 1956:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1956	$5,000	$10,000	$7,500	$2,500	[1] $25,000
1955	5,000	7,500	5,000	2,500	[2] 20,000
1954	3,770	5,026	2,513	1,257	[3] 12,566
Total	$13,770	$22,526	$15,013	$6,257	$57,566

[1] See paragraph (d)(2). [2] See paragraph (e)(3). [3] See paragraph (f)(3).

Thus, B will include in gross income for 1956 dividends of $13,770 (subject to the dividend exclusion), rents of $22,526, and taxable interest of $15,013, and will exclude the tax-exempt interest of $6,257.

(2) *Computation of tax.*—(i) For the purpose of computing B's tax liability, it is assumed that he was single during the taxable years 1954, 1955, and 1956, and that his taxable income (derived from salary) for each of the years 1954 and 1955 amounted to $13,400 on which a tax of $4,002 was paid for each year. It is also assumed that his income (other than distributions from the trust) for 1956 was $15,000 derived from salary, and he had allowable deductions of $10,600, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1956 attributable to the section 666 amounts which are included in B's gross income for such year, as provided in paragraph (a) (1) of § 1.668(a)–4, is as follows:

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Salary	$15,000	$15,000
Income from trust:		
Dividends ($50 excluded)	4,950	13,720
Rents	10,000	22,526
Taxable interest	7,500	15,013
Total	$37,450	$66,259
Less: Allowable deductions	10,600	10,600
Taxable income	$26,850	$55,659
Total tax	$11,267	$31,064
Less: Dividend received credit	198	475
Tax liability	$11,069	$30,589
Tax on income from which section 666 amounts are excluded		11,069
1956 tax attributable to section 666 amounts		$19,520

Only that portion of the dividends received by the trust after July 31, 1954, and deemed distributed to B under section 666, on the last day of such year is included in computing the dividend received credit shown in column (2). See paragraph (f) (3).

(iii) The computation of the taxes for the preceding taxable years attributable to the section 666 amounts which are deemed distributed by the trust on the last day of these years, as provided in paragraph (a) (2) of § 1.668(a)–4, is as follows:

	Preceding taxable years	
	First, 1955	Second, 1954
Taxable income previously reported	$13,400	$13,400
Section 666 amounts:		
Dividends ($50 excluded)	4,950	3,720
Rents	7,500	5,026
Taxable interest	5,000	2,513
Taxable income as adjusted	$30,850	$24,659
Total tax	$13,747	$9,949
Less: Dividend received credit	198	75
Balance of tax	$13,549	$9,874
Tax liability	4,002	4,002
Tax attributable to section 666 amounts	$9,547	$5,872

Only that portion ($1,885) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $75 for the year 1954. See paragraph (f) (3).

(iv) Inasmuch as the aggregate of the taxes of $15,419 ($9,547 plus $5,872) attributable to the section 666 amounts as determined for the preceding taxable years is less than the tax of $19,520 determined for the taxable year 1956, the amount of $15,419 shall be added to the tax computed for 1956 without including the section 666 amounts. Thus, B's tax liability for 1956 is $26,488 ($11,069 plus $15,419).

(3) *Credits against the tax.*—B is allowed under section 668(b) a credit of $12,516 ($5,401 for 1954 and $7,115 for 1955) against his 1956 tax liability for the taxes paid by the trust for the preceding taxable years and which may not be refunded or credited to the trust under section 667. See paragraphs (e) (4) and (f) (4).

(i) [*Reserved*]

(j) *Taxable year 1957.*—(1) *Amount of trust income includible in gross income.*—(i) Of the amount of $29,550 distributed by the trust to B during the taxable year 1957, $22,500 is treated as a distribution out of trust income for that year within the meaning of section 662(a) (2), and $7,050 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d)). However, $6,990 plus taxes of $5,444 is deemed distributed to B on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1957, and that amount is includible in B's gross income for 1957, to the extent that it would have been includible in his gross income under section 662(a) (2) and (b) for 1954, had it been distributed on the last day of that year.

(ii) The amounts deemed distributed to B out of trust income for the year 1957 and the preceding taxable year 1954 are deemed to have the following character for the purpose of determining the amount includible in B's gross income for 1957:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	$5,000	$7,500	$7,500	$2,500	[1] $22,500
1954	3,730	4,974	2,487	1,243	[2] 12,434
Total	$8,730	$12,474	$9,987	$3,743	$34,934

[1] See paragraph (d)(2).
[2] See paragraph (g)(2).

Thus, B will include in gross income for the year 1957 dividends of $8,730 (subject to the dividend exclusion), rents of $12,474, and taxable interest of $9,987 and will exclude the tax-exempt interest of $3,743.

(2) *Computation of tax.*—(i) For the purpose of computing B's tax liability for 1957, it is assumed that he was single for the entire year and had income (other than distributions from the trust) of $15,000 from salary. Also, he had allowable deductions of $8,100, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1957, attributable to the section 666 amounts which are included in B's gross income for that year, as provided in paragraph (a)(1) of § 1.668(a)-4, is as follows:

	Section 666 amounts excluded	Section 666 amounts included
Salary	$15,000	$15,000
Trust income:		
Dividends ($50 excluded)	4,950	8,680
Rents	7,500	12,474
Taxable interest	7,500	9,987
Total	$34,950	$46,141
Less: Allowable deductions	8,100	8,100
Taxable income	$26,850	$38,041
Total tax	$11,267	$18,388
Less: Dividends received credit	198	275
Tax liability	$11,069	$18,113
Tax on income from which section 666 amounts are excluded		11,069
1957 tax attributable to section 666 amounts		$7,044

See explanation following computation in paragraph (h)(2)(ii) with respect to the computation of the dividend received credit on dividends received by the trust in 1954.

(iii) The amount of tax, computed at 1954 rates, attributable to the section 666 amounts which are deemed to have been distributed by the trust on the last day of 1954, is $6,939, computed as follows:

1954 taxable income as adjusted (paragraph (h)(2)(iii))		$24,659
Section 666 amounts:		
Dividends		3,730
Rents		4,974
Taxable interest		2,487
Taxable income as adjusted		$35,850
Total tax		$16,963
Less: Dividends received credit		150
Balance of tax		$16,813
Tax liability for 1954	$4,002	
Tax attributable to 1956 accumulation distribtuion (paragraph (h)(2)(iii))	5,872	
		9,874
Tax attributable to the section 666 amounts distributed in 1957		$6,939

Only that portion ($3,750) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $150. See paragraphs (f)(3) and (g)(2).

(iv) Inasmuch as the tax of $6,939 attributable to the section 666 amounts as determined for the preceding taxable year 1954 is less than the tax of $7,044 attributable to these amounts for the year 1957, the amount of $6,939 shall be added to the tax computed for 1957 without including in gross income the section 666 amounts. Thus, B's tax liability for 1957 is $18,008 ($11,069 plus $6,939).

(3) *Credit against the tax.*—B is allowed under section 668(b) a credit of $5,444 against his 1957 tax liability for the balance of the taxes paid by the trust for 1954 and which may not be refunded or credited to the trust under section 667. See paragraph (g)(3) of this example.

Grantors and Others Treated as Substantial Owners

§ 1.671 Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners.

SEC. 671. TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS

Where is it specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

§ 1.671–1 Grantors and Others Treated as Substantial Owners; Scope.—(a) Sections 671–678 (subpart E of subchapter J) con-

tain provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under sections 641–668 (subparts A through D). Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673–677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675);

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671–677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in sections 671–678 (subpart E), income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of sections 671–678 do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671–677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of sections 671–678 even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See § 1.662(a)–4. He is then treated as a beneficiary under sections 641–668 (subparts A through D) or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) For the effective date of sections 671–678 (subpart E) see section 683 and the regulations thereunder.

§ 1.671–2 Applicable Principles.—(a) Under section 671 a grantor or another person includes in computing his taxable income

and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673–678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in § 1.671–3.

(b) Since the principle underlying sections 671–678 (subpart E) is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)–1), is meant, the phrase "ordinary income" is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671–677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under sections 671–678 (subpart E) will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under sections 671–678 (subpart E) are subject to the provisions of sections 641–668 (subparts A through D of subchapter J).

(e) The term "grantor" as used in the regulations under subpart E includes a corporation.

§ 1.671–3 Attribution or Inclusion of Income, Deductions, and Credits Against Tax.—(a) When a grantor or another person is treated under sections 671–678 (subpart E) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example—

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income,

deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of sections 641–668 (subparts A through D). Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of sections 641–668 (subparts A through D). See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example—

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674–678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to re-

quire that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676(a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deduction, and credit which would not be included under sections 641–668 (subparts A through D) in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under sections 641–668 (subparts A through D), such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For

examples of computations under this paragraph see paragraph (g) of § 1.677(a)-1.

§ 1.671-4 METHOD OF REPORTING.—Items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of sections 671-678 (subpart E) are treated as owned by the grantor or another person should not be reported by the trust on Form 1041, but should be shown on a separate statement to be attached to that form.

§ 1.672(a) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; DEFINITION OF ADVERSE PARTY.

SEC. 672. DEFINITIONS AND RULES.

(a) ADVERSE PARTY.—For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

§ 1.672(a)-1 DEFINITION OF ADVERSE PARTY.—(a) Under section 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

(c) The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under sections 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to

the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

(d) The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).

§ 1.672(b) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Definition of Nonadverse Party.

SEC. 672. DEFINITIONS AND RULES. * * *

(b) Nonadverse Party.—For purposes of this subpart, the term "nonadverse party" means any person who is not an adverse party.

§ 1.672(b)-1 Nonadverse Party.—A "nonadverse party" is any person who is not an adverse party.

§ 1.672(c) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Definition of Related or Subordinate Party.

SEC. 672. DEFINITIONS AND RULES. * * *

(c) Related or Subordinate Party.—For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is—

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

§ 1.672(c)-1 Related or Subordinate Party.—Section 672(c) defines the term "related or subordinate party". The term, as used in sections 674(c) and 675(3), means any nonadverse party who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. For purposes of sections 674(c) and 675(3), these persons are presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on them unless shown not to be subservient by a preponderance of the evidence.

§ 1.672(d) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; RULE WHERE POWER IS SUBJECT TO CONDITION PRECEDENT.

SEC. 672. DEFINITIONS AND RULES. * * *

(d) RULE WHERE POWER IS SUBJECT TO CONDITION PRECEDENT.—A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

§ 1.672(d)-1 POWER SUBJECT TO CONDITION PRECEDENT.—Section 672(d) provides that a person is considered to have a power described in sections 671-678 even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

§ 1.673(a) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; REVERSIONARY INTERESTS.

SEC. 673. REVERSIONARY INTERESTS.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

§ 1.673(a)-1 REVERSIONARY INTERESTS; INCOME PAYABLE TO BENEFICIARIES OTHER THAN CERTAIN CHARITABLE ORGANIZATIONS; GENERAL RULE.—(a) Under section 673(a), a grantor, in general, is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion of the trust, the grantor's interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of transfer of that portion of the trust. However, the following types of reversionary interests are excepted from the general rule of the preceding sentence:

(1) A reversionary interest after the death of the income beneficiary of a trust (see paragraph (b) of this section); and

(2) A reversionary interest in a charitable trust meeting the requirements of section 673(b) (see § 1.673(b)-1).

Even though the duration of the trust may be such that the grantor is not treated as its owner under section 673, and therefore is not taxed on the ordinary income, he may nevertheless be treated as an owner under section 667(a)(2) if he has a reversionary interest in the corpus. In the latter case, items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns. See § 1.671-3 and the regulations under section 677. See § 1.673(d)-1 with respect to a postponement of the date specified for reacquisition of a reversionary interest.

(b) Section 673(c) provides that a grantor is not treated as the owner of any portion of a trust by reason of section 673 if his reversionary interest in the portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the portion is payable, regardless of the life expectancies of the income beneficiaries. If his reversionary interest is to take effect on or after the death of an income beneficiary or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner if the specific term of years is less than 10 years (but not if the term is 10 years or longer).

(c) Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under section 673 if the event may not reasonably be expected to occur within 10 years from that date. For example, if the reversionary interest in any portion of a trust is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) the grantor is treated under section 673 as the owner of the portion if the life expectancy of the grantor (or other person) is less than 10 years on the date of transfer of the portion, but not if the life expectancy is 10 years or longer. If the reversionary interest in any portion is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner of the portion if on the date of transfer of the portion either the life expectancy of the grantor (or other person) or the specific term is less than 10 years; however, if both the life expectancy and the specific term are 10 years or longer the grantor is not treated as the owner of the portion under section 673. Similarly, if the grantor has a reversionary interest in any portion which will take effect at the death of the income beneficiary or the grantor, whichever is earlier, the grantor is not treated as an owner of the portion unless his life expectancy is less than 10 years.

(d) It is immaterial that a reversionary interest in corpus or income is subject to a contingency if the reversionary interest may, taking the contingency into consideration, reasonably be expected to take

effect in possession or enjoyment within 10 years. For example, the grantor is taxable where the trust income is to be paid to the grantor's son for 3 years, and the corpus is then to be returned to the grantor if he survives that period, or to be paid to the grantor's son if he is already deceased.

(e) See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.673(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; CHARITABLE BENEFICIARIES.

SEC. 673. REVERSIONARY INTERESTS. * * *

(b) EXCEPTION WHERE INCOME IS PAYABLE TO CHARITABLE BENEFICIARIES.—Subsection (a) shall not apply to the extent that the income of a portion of a trust in which the grantor has a reversionary interest is, under the terms of the trust, irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary, which beneficiary is of a type described in section 170(b)(1)(A)(i), (ii), or (iii).

§ 1.673(b)–1 INCOME PAYABLE TO CHARITABLE BENEFICIARIES.—(a) Pursuant to section 673(b) a grantor is not treated as an owner of any portion of a trust under section 673, even though he has a reversionary interest which will take effect within 10 years, to the extent that, under the terms of the trust, the income of the portion is irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary of the type described in section 170(b)(1)(A)(i), (ii), or (iii); that is, to a church or a convention or association of churches, or to certain educational organizations or hospitals. For definitions of these terms see the regulations under section 170.

(b) Income must be irrevocably payable to a designated beneficiary for at least 2 years commencing with the date of the transfer before the benefit of section 673(b) will apply. Thus, section 673(b) will not apply if income of a trust is irrevocably payable to University A for 1 year and then to University B for the next year; or if income of a trust may be allocated among two or more charitable beneficiaries in the discretion of the trustee or any other person. On the other hand, section 673(b) will apply if half the income of a trust is irrevocably payable to University A and the other half is irrevocably payable to University B for two years.

(c) Section 673(b) applies to the period of 2 years or longer during which income is paid to a designated beneficiary of the type described in section 170(b)(1)(A)(i), (ii), or (iii), even though the trust term is to extend beyond that period. However, the other provisions of section 673 apply to the part of the trust term, if any, that extends beyond that period. This paragraph may be illustrated by the following example:

Example.—G transfers property in trust with the ordinary income payable to University C (which qualifies under section 170(b)(1)(A)(ii)) for 3 years, and then to his son, B, for 5 years. At the expiration of the term the trust reverts to G. G is not taxed under section 673 on the trust income payable to University C for the first 3 years because of the application of section 673(b). How-

ever, he is taxed on income for the next 5 years because he has a reversionary interest which will take effect within 10 years commencing with the date of the transfer. On the other hand, if the income were payable to University C for 3 years and then to B for 7 years so that the trust corpus would not be returned to G within 10 years, G would not be taxable under section 673 on income payable to University C and to B during any part of the term.

§1.673(c) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; REVERSIONARY INTEREST TAKING EFFECT AT DEATH OF INCOME BENEFICIARY.

SEC. 673. REVERSIONARY INTERESTS. * * *

(c) REVERSIONARY INTEREST TAKING EFFECT AT DEATH OF INCOME BENEFICIARY.—The grantor shall not be treated under subsection (a) as the owner of any portion of a trust where his reversionary interest in such portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable.

§ 1.673(c)-1 REVERSIONARY INTEREST AFTER INCOME BENEFICIARY'S DEATH.—The subject matter of section 673(c) is covered in § 1.673 (a)-1(b).

§ 1.673(d) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; POSTPONEMENT OF DATE SPECIFIED FOR REACQUISITION.

SEC. 673. REVERSIONARY INTERESTS. * * *

(d) POSTPONEMENT OF DATE SPECIFIED FOR REACQUISITION.—Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

§ 1.673(d)-1 POSTPONEMENT OF DATE SPECIFIED FOR REACQUISITION.—Any postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, the grantor will not be treated as the owner of any portion of a trust for any taxable year by reason of the foregoing sentence if he would not be so treated in the absence of any postponement. The rules contained in this section may be illustrated by the following example:

Example.—G places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to G or his estate. After the expiration of 9 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G is treated as the owner of the trust, however, for the remaining 2 years.

§ 1.674(a) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Power To Control Beneficial Enjoyment.

SEC. 674. POWER TO CONTROL BENEFICIAL ENJOYMENT.

(a) General Rule.—The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

§ 1.674(a)–1 Power To Control Beneficial Enjoyment; Scope of Section 674.—(a) Under section 674, the grantor is treated as the owner of a portion of trust if the grantor or a nonadverse party has a power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Section 674(a) states in general terms that the grantor is treated as the owner in every case in which he or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsections (b), (c), and (d) of section 674. These exceptions are discussed in detail in §§ 1.674(b)–1 through 1.674(d)–1. Certain limitations applicable to sections 674(b), (c), and (d) are set forth in § 1.674(d)–2. Section 674(b) describes powers which are excepted regardless of who holds them. Section 674(c) describes additional powers of trustees which are excepted if at least half the trustees are independent, and if the grantor is not a trustee. Section 674(d) describes a further power which is excepted if it is held by trustees other than the grantor or his spouse (if living with the grantor).

(b) In general terms the grantor is treated as the owner of a portion of a trust if he or a nonadverse party or both has a power to dispose of the beneficial ejoyment of the corpus or income unless the power is one of the following:

(1) *Miscellaneous powers over either ordinary income or corpus.*—(i) A power that can only affect the beneficial enjoyment of income (including capital gains) received after a period of time such that the grantor would not be treated as an owner under section 673 if the power were a reversionary interest (section 674(b)(2));

(ii) A testamentary power held by anyone (other than a testamentary power held by the grantor over accumulated income) (section 674(b)(3));

(iii) A power to choose between charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest (section 674(b)(4));

(iv) A power to allocate receipts and disbursements between income and corpus (section 674(b)(8)).

(2) *Powers of distribution primarily affecting only one beneficiary.*—(i) *A power to distribute corpus* to or for a current income beneficiary, if the distribution must be charged against the share of corpus from which the beneficiary may receive income (section 674(b)(5)(B));

(ii) *A power to distribute income* to or for a current income beneficiary or to accumulate it either (*a*) if accumulated income must

either be payable to the beneficiary from whom it was withheld or as described in paragraph (b)(6) of § 1.674(b)–1 (section 674(b)(6)); (*b*) if the power is to apply income to the support of a dependent of the grantor, and the income is not so applied (section 674(b)(1)); or (*c*) if the beneficiary is under 21 or under a legal disability and accumulated income is added to corpus (section 674(b)(7)).

(3) *Powers of distribution affecting more than one beneficiary.*—A power to distribute corpus or income to or among one or more beneficiaries or to accumulate income, either (i) if the power is held by a trustee or trustees other than the grantor, at least half of whom are independent (section 674(c)), or (ii) if the power is limited by a reasonably definite standard in the trust instrument, and in the case of a power over income, if in addition the power is held by a trustee or trustees other than the grantor and the grantor's spouse living with the grantor (sections 674(b)(5)(A) and 674(d)). (These powers include both powers to "sprinkle" income or corpus among current beneficiaries, and powers to shift income or corpus between current beneficiaries and remaindermen; however, certain of the powers described under subparagraph (2) above of this paragraph can have the latter effect incidentally.)

(c) See section 671 and §§ 1.671–2 and 1.671–3 for rules for the treatment of income, deductions, and credits when a person is treated as the owner of all or only a portion of a trust.

§ 1.674(b) Statutory Provisions; Estates and Trust; Grantors and Others Treated as Substantial Owners; Exceptions for Certain Powers To Control Beneficial Enjoyment.

SEC. 674. POWER TO CONTROL BENEFICIAL ENJOYMENT. * * *

(b) Exceptions for Certain Powers.—Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) Power to apply income to support of a dependent.—A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after expiration of 10-year period.—A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a revisionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

(3) Power exercisable only by will.—A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) Power to allocate among charitable beneficiaries.—A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions).

(5) Power to distribute corpus.—A power to distribute corpus either—

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonable definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the

distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) POWER TO WITHHOLD INCOME TEMPORARILY.—A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) POWER TO WITHHOLD INCOME DURING DISABILITY OF A BENEFICIARY.—A power exercisable only during—

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the power described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or adter-adopted children.

(8) POWER TO ALLOCATE BETWEEN CORPUS AND INCOME.—A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

§ 1.674(b)-1 EXCEPTED POWERS EXERCISABLE BY ANY PERSON.—(a) Subparagraphs (1) through (8) of paragraph (b) of this section set forth a number of powers which may be exercisable by any person without causing the grantor to be treated as an owner of a trust under section 674(a). Further, with the exception of powers described in subparagraph (1) of paragraph (b) of this section, it is immaterial whether these powers are held in the capacity of trustee. It makes no difference under section 674(b) that the person holding the power is the grantor, or a related or subordinate party (with the qualifications noted in subparagraphs (1) and (3) of paragraph (b) of this section).

(b) The exceptions referred to in paragraph (a) of this section are as follows (see, however, the limitations set forth in § 1.674(d)-2 below):

(1) *Powers to apply income to support of a dependent.*—Section 674(b)(1) provides, in effect, that regardless of the general rule of section 674(a), the income of a trust will not be considered as taxable to the grantor merely because in the discretion of any person (other than a grantor who is not acting as a trustee or cotrustee) it may be used for the support of a beneficiary whom the grantor is legally obligated to support, except to the extent that it is in fact used for that purpose. See section 677(b) and the regulations thereunder.

(2) *Powers affecting beneficial enjoyment only after a period.*—Section 674(b)(2) provides an exception to section 674(a) if the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. For example, if a trust created on January 1, 1955, provides for the payment of income to the grantor's son, and the grantor reserves the power to substitute other beneficiaries of income or corpus in lieu of his son on or after January 1, 1965, the grantor is not treated under section 674 as the owner of the trust with respect to ordinary income received before January 1, 1965. But the grantor will be treated as an owner on and after that date unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)–1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(3) *Testamentary powers.*—Under paragraph (3) of section 674(b) a power in any person to control beneficial enjoyment exercisable only by will does not cause a grantor to be treated as an owner under section 674(a). However, this exception does not apply to income accumulated for testamentary disposition by the grantor or to income which may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. For example, if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. (See § 1.671–3.)

(4) *Powers to determine beneficial enjoyment of charitable beneficiaries.*—Under paragraph (4) of section 674(b) a power in any person to determine the beneficial enjoyment of corpus or income which is irrevocably payable (currently or in the future) for purposes specified in section 170(c) (relating to definition of charitable contributions) will not cause the grantor to be treated as an owner under section 674(a). For example, if a grantor creates a trust, the income of which is irrevocably payable solely to educational or other organizations that qualify under section 170(c), he is not treated as an

owner under section 674 although he retains the power to allocate the income among such organizations.

(5) *Powers to distribute corpus.*—Paragraph (5) of section 674(b) provides an exception to section 674(a) for powers to distribute corpus, subject to certain limitations, as follows:

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674(b)(5)(A). It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living: or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674(b)(5)(B).

(iii) This subparagraph may be illustrated by the following examples:

Example (1). A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares. The grantor reserves the power to distribute corpus to pay medical expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674(b)(5)(A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674(b)(5)(A) would not be applicable.

Example (2). The facts are the same as in example (1) except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5)(A) of section 674(b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5)(B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example (3). A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674(a) by reason of this power because it qualifies under the exception of section 674(b)(5)(B).

(6) *Powers to withhold income temporarily.*—(i) Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either—

(*a*) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A));

(*b*) To the beneficiary from whom it was withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(A) and the flush material following); or

(*c*) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or

the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(B) and the flush material following).

(In the application of (*a*) of this subdivision, if the accumulated income of a trust is ultimately payable to the estate of the current income beneficiary, or is ultimately payable to his appointees, or takers in default of appointment, under a power of the type described in (*a*) of this subdivision, it need not be payable to the beneficiary from whom it was withheld under any circumstances. Furthermore, if a trust otherwise qualifies for the exception in (*a*) of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in (*a*) of this subdivision.) In general, the exception in section 674(b)(6) is not applicable if the power is in substance one to shift ordinary income from one beneficiary to another. Thus, a power will not qualify for this exception if ordinary income may be distributed to beneficiary A, or may be added to corpus which is ultimately payable to beneficiary B, a remainderman who is not a current income beneficiary. However, section 674(b)(6)(B), and (*c*) of this subdivision, permit a limited power to shift ordinary income among current income beneficiaries, as illustrated in example (1) of this subparagraph.

(ii) The application of section 674(b)(6) may be illustrated by the following examples:

Example (1). A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other (since the corpus with the accumulations is to be divided equally) the power is excepted under section 674(b)(6)(B) and subdivision (i) (*c*) of this subparagraph.

Example (2). The facts are the same as in example (1), except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section 674(b)(6)(B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. See, however, section 674(c) and § 1.674(c)–1 for the effect of such a power if it is exercisable only by independent trustees.

Example (3). A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the

grantor's estate) in specified shares. The power is excepted under section 674(b)(6)(A) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime. It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.

(7) *Power to withhold income during disability.*—Section 674(b)(7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the power to accumulate income and add it to corpus while his son is under 21.

(8) *Powers to allocate between corpus and income.*—Paragraph (8) of section 674(b) provides that a power to allocate receipts and disbursements between corpus and income, even though expressed in broad language, will not cause the grantor to be treated as an owner under the general rule of section 674(a).

§ 1.674(c) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Exception for Certain Powers of Independent Trustees.

SEC. 674. POWER TO CONTROL BENEFICIAL ENJOYMENT. * * *

(c) Exception for Certain Powers of Independent Trustees.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

§ 1.674(c)-1 Excepted Powers Exercisable Only by Independent Trustees.—Section 674(c) provides an exception to the general rule of section 674(a) for certain powers that are exercisable by independent trustees. This exception is in addition to those provided for under section 674(b) which may be held by any person including an independent trustee. The powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for

a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (See section 672(c) for definitions of these terms.) An example of the application of section 674(c) is a trust whose income is payable to the grantor's three adult sons with power in an independent trustee to allocate without restriction the amounts of income to be paid to each son each year. Such a power does not cause the grantor to be treated as the owner of the trust. See, however, the limitations set forth in § 1.674(d)-2.

§ 1.674(d) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Power to Allocate Income if Limited by a Standard.

SEC. 674. POWER TO CONTROL BENEFICIAL ENJOYMENT. * * *

(d) Power To Allocate Income if Limited by a Standard.—Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

§ 1.674(d)-1 Excepted Powers Exercisable by any Trustees Other Than Grantor or Spouse.—Section 674(d) provides an additional exception to the general rule of section 674(a) for a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, whether or not the conditions of section 674(b) (6) or (7) are satisfied, if the power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, and if the power is limited by a reasonably definite external standard set forth in the trust instrument (see paragraph (b) (5) of § 1.674(b)-1 with respect to what constitutes a reasonably definite standard). See, however, the limitations set forth in § 1.674(d)-2.

§ 1.674(d)-2 Limitations on Exceptions in Section 674(b), (c), and (d).—(a) *Power to remove trustee.*—A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674(c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person

including himself as trustee, the trust will not qualify under section 674(c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674(c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).

(b) *Power to add beneficiaries.*—The exceptions described in sections 674(b)(5), (6), and (7), and 674(c) and (d) are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

§ 1.675 Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Administrative Powers.

SEC. 675. ADMINISTRATIVE POWERS.

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) POWER TO DEAL FOR LESS THAN ADEQUATE AND FULL CONSIDERATION.—A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) POWER TO BORROW WITHOUT ADEQUATE INTEREST OR SECURITY.—A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) BORROWING OF THE TRUST FUNDS.—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.

(4) GENERAL POWERS OF ADMINISTRATION.—A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of

stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

§ 1.675-1 Administrative Powers.—(a) *General rule.*—Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception. See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) *Prohibited controls.*—The circumstances which cause administrative controls to be considered exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) through (4) of section 675 as follows:

(1) The existence of a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income of the trust for less than adequate consideration in money or money's worth. Whether the existence of the power itself will constitute the holder an adverse party will depend on the particular circumstances.

(2) The existence of a power exercisable by the grantor or a nonadverse party, or both, which enables the grantor to borrow the corpus or income of the trust, directly or indirectly, without adequate interest or adequate security. However, this paragraph does not apply where a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security. A general lending power in the grantor, acting alone as trustee, under which he has power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has power to borrow the corpus or income without adequate interest or security.

(3) The circumstance that the grantor has directly or indirectly borrowed the corpus or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence does not apply to a loan which provides for adequate interest and adequate security, if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. See section 672(c) for definition of "a related or subordinate party."

(4) The existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term

"powers of administration" means one or more of the following powers:

(i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control:

(ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

(c) *Authority of trustee.*—The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

§ 1.676(a) STATUTORY PROVISIONS: ESTATES AND TRUSTS: GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; POWER TO REVOKE: GENERAL RULE.

SEC. 676. POWER TO REVOKE.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is excercisable by the grantor or a non-adverse party, or both.

§ 1.676(a)-1 POWER TO REVEST TITLE TO PORTION OF TRUST PROPERTY IN GRANTOR; GENERAL RULE.—If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a non-adverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a non-adverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and §§ 1.671-2 and 1.671-3 for

rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

§ 1.676(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; POWER TO REVOKE EXERCISABLE ONLY AFTER A PERIOD OF TIME.

SEC. 676. POWER TO REVOKE. * * *

(b) POWER AFFECTING BENEFICIAL ENJOYMENT ONLY AFTER EXPIRATION OF 10-YEAR PERIOD.—Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished.

§ 1.676(b)-1 POWERS EXERCISABLE ONLY AFTER A PERIOD OF TIME.—Section 676(b) provides an exception to the general rule of section 676(a) when the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)-1 and 1.673(b)-1. Thus, for example, a grantor is excepted from the general rule of section 676(a) with respect to ordinary income if exercise of a power to revest corpus in him cannot affect the beneficial enjoyment of the income received within 10 years after the date of transfer of that portion of the trust. It is immaterial for this purpose that the power is vested at the time of the transfer. However, the grantor is subject to the general rule of section 676(a) after the expiration of the period unless the power is relinquished. Thus, in the above example, the grantor may be treated as the owner and be taxed on all income in the eleventh and succeeding years if exercise of the power can affect beneficial enjoyment of income received in those years. If the beginning of the period during which the grantor may revest is postponed, the rules set forth in § 1.673(d)-1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.

§ 1.677(a) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; INCOME FOR BENEFIT OF GRANTOR; GENERAL RULE.

SEC. 677. INCOME FOR BENEFIT OF GRANTOR.

(a) GENERAL RULE.—The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party, or both, may be—

(1) distributed to the grantor;

(2) held or accumulated for future distribution to the grantor; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but

the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

§ 1.677(a)-1 INCOME FOR BENEFIT OF GRANTOR; GENERAL RULE.—(a) Section 677 deals with situations in which a grantor of a trust is treated as the owner of a portion of the trust because he has retained an interest in the income from that portion. See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) Under section 677, the grantor is treated in any taxable year as the owner of a portion of a trust (whether or not he is treated as an owner under section 674) of which the income for the taxable year or for a period not coming within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a nonadverse party, or both, (without the approval or consent of any adverse party) may be—

(1) Distributed to the grantor;

(2) Held or accumulated for future distribution to the grantor; or

(3) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

(c) Therefore, under the general rule of section 677 the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from the portion, at some time, distributed to him either actually or constructively (subject to the exception described in paragraph (e) of this section). Constructive distribution to the grantor includes payment to another in obedience to his direction and payment of premiums upon policies of insurance on the grantor's life (other than policies of insurance irrevocably payable for charitable purposes). If the grantor strips himself permanently and definitively of every interest described in the first sentence of this paragraph, he is not treated as an owner under section 677 after that divesting. The word "interest" as used in the first sentence of this paragraph does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust by inheritance, or as a surviving spouse under a statutory right of election or a similar right.

(d) Under section 677 a grantor is, in general, treated as owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be, applied in discharge of a legal obligation of the grantor. However, see § 1.677(b)-1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor other than the support or maintenance of a beneficiary whom the grantor is legally obligated to support.

(e) The last sentence of section 677(a) provides an exception to the general rule when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner

under section 673 if the power were a reversionary interest. See §§ 1.673(a)-1 and 1.673(b)-1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor, the grantor is not treated as an owner with respect to ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)-1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(f) However, if income is accumulated in any taxable year for future distribution to the grantor, section 677(a)(2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor must await the expiration of a period of time before he can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor may be, distributed to the grantor, the grantor is treated as the owner of the trust from its inception.

(g) The application of section 677(a) may be illustrated by the following examples:

Example (1). G creates an irrevocable trust which provides that the ordinary income is to be payable to himself for life and that on his death the corpus shall be distributed to a designated charity. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671–677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1955 the trust has the following items of gross income and deductions:

Dividends	$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1955. He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See § 1.671-3. The tax consequences of the capital gain are governed by the provisions of sections 641–668 (subparts A, B, C and D). Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of sections 641–668.

Example (2). G creates a trust whose ordinary income is payable to his adult son. Ten years from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G.

In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retains no other right or power which would cause him to be treated as an owner under subpart E. Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1955 the trust had the following items of income and deductions:

Dividends	$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition, because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of $5,000. Accordingly, G includes dividends of $5,208.33 and income expenses of $208.33 in computing his taxable income, determined in the following manner:

Total dividends	$10,000
Less: Expenses allocable to income	400
Distributable income of the trust	$9,600
Portion of dividends attributable to G (5,000/9,600×$10,000)	$5,208.33
Portion of income expenses attributable to G (5,000/9,600×$400)	208.33
Amount of income subject to discretionary right	$5,000.00

In accordance with paragraph (c) of § 1.671–3, G also takes into account $104.17 (5,000/9,600×$200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of sections 641–668 (subparts A through D).

§ 1.677(b) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Trusts for Support of Grantor's Dependents.

SEC. 677. INCOME FOR BENEFIT OF GRANTOR. * * *

(b) Obligations of Support.—Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

§ 1.677(b)-1 TRUSTS FOR SUPPORT.—(a) Section 677(b) provides in effect that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person except the grantor not acting as trustee or cotrustee be applied or distributed for the support or maintenance of a beneficiary, such as the wife or child of the grantor, whom the grantor is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes.

(b) If any amount applied or distributed for the support of a beneficiary whom the grantor is legally obligated to support is paid out of corpus or out of other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661(a)(2), taxable to the grantor under section 662. Thus, he is subject to the other relevant portions of sections 641–668 (subparts A through D). Accordingly, the grantor may be taxed on an accumulation distribution under sections 665 through 668 (subpart D). The provisions of those sections, including the exceptions in section 665, are applied on the basis that the grantor is the beneficiary.

(c) For the purpose of determining the items of income, deduction, and credit of a trust to be included under this section in computing the grantor's tax liability, the income of the trust for the taxable year of distribution will be deemed to have been first distributed. For example, in the case of a trust reporting on the calendar year basis, a distribution made on January 1, 1956, will be deemed to have been made out of ordinary income of the trust for the calendar year 1956 to the extent of the income for that year even though the trust had received no income as of January 1, 1956. Thus, if a distribution of $10,000 is made on January 1, 1956, for the support of the grantor's dependent, the grantor will be treated as the owner of the trust for 1956 to that extent. If the trust received dividends of $5,000 and incurred expenses of $1,000 during that year but subsequent to January 1, he will take into account dividends of $5,000 and expenses of $1,000 in computing his tax liability for 1956. In addition, the grantor will be treated as a beneficiary of the trust with respect to the $6,000 ($10,000 less distributable income of $4,000 (dividends of $5,000 less expenses of $1,000)) paid out of corpus or out of other than income of the current year. See paragraph (b) of this section.

(d) The exception provided in section 677(b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677(a) is applicable when in the discretion of the grantor or nonadverse parties income of a trust may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust regardless of whether the income is actually so applied.

(e) The general rule of section 677(a), and not section 677(b),

is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or cotrustee.

(f) The general rule of section 677(a), and not section 677(b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

§ 1.678 (a) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER; GENERAL RULE.

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

(a) GENERAL RULE.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

§ 1.678(a)-1 PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER; GENERAL RULE.—(a) Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, except as provided in section 678(b) (involving taxation of the grantor) and section 678(c) (involving an obligation of support). The holder of such a power also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under sections 671 to 677, inclusive. See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.

(b) Section 678(a) treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations, other than an obligation to support a dependent (see § 1.678(c)-1) subject to the limitation of section 678(b). Section 678 does not apply if the power is not exercisable solely hy himself. However, see § 1.662(a)-4 for principles applicable to income of a trust which, pursuant to the terms of the trust instrument, is used to satisfy the obligations of a person other than the grantor.

§ 1.678(b) STATUTORY PROVISIONS; ESTATES AND TRUSTS; GRANTORS AND OTHERS TREATED AS SUBSTANTIAL OWNERS; EXCEPTION WHERE GRANTOR IS TAXABLE.

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER. * * *

(b) EXCEPTION WHERE GRANTOR IS TAXABLE.—Subsection (a) shall not apply with respect to a power over income, as originally granted or there-

after modified, if the grantor of the trust is otherwise treated as the owner under sections 671 to 677, inclusive.

§ 1.678(b)–1 If Grantor Is Treated as the Owner.—Section 678(a) does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is treated as the owner under section 671 to 677, inclusive.

§ 1.678(c) Statutory Provisions; Estate and Trusts; Grantors and Others Treated as Substantial Owners; Trusts for Support.

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER. * * *

(c) Obligations of Support.—Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

§ 1.678(c)–1 Trusts for Support.—(a) Section 678(a) does not apply to a power which enables the holder, in the capacity of trustee or cotrustee, to apply the income of the trust to the support or maintenance of a person whom the holder is obligated to support, except to the extent the income is so applied. See paragraphs (a), (b), and (c) of § 1.677(b)–1 for applicable principles where any amount is applied for the support or maintenance of a person whom the holder is obligated to support.

(b) The genreal rule in section 678(a) (and not the exception in section 678(c)) is applicable in any case in which the holder of a power exercisable solely by himself is able, in any capacity other than that of trustee or cotrustee, to apply the income in discharge of his obligation of support or maintenance.

(c) Section 678(c) is concerned with the taxability of income subject to a power described in section 678(a). It has no application to the taxability of income which is either required to be applied pursuant to the terms of the trust instrument or is applied pursuant to a power which is not described in section 678(a), the taxability of such income being governed by other provisions of the Internal Revenue Code of 1954. See § 1.662(a)–4.

§ 1.678(d) Statutory Provisions; Estates and Trusts; Grantors and Others Treated as Substantial Owners; Effect of Renunciation or Disclaimer.

SEC. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER. * * *

(d) Effect of Renunciation or Disclaimer.—Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

§ 1.678(d)–1 Renunciation of Power.—Section 678(a) does not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

§ 1.683 STATUTORY PROVISIONS: ESTATES AND TRUSTS; APPLICABILITY OF PROVISIONS.

SEC. 683. APPLICABILITY OF PROVISIONS.

(a) GENERAL RULE.—This part shall apply only to taxable years beginning after December 31, 1953, and ending after the date of the enactment of this title.

(b) EXCEPTIONS.—In the case of any beneficiary of an estate or trust—

(1) this part shall not apply to any amount paid, credited, or to be distributed by the estate or trust in any taxable year of such estate or trust to which this part does not apply, and

(2) the Internal Revenue Code of 1939 shall apply for purposes of determining the amount includible in the gross income of the beneficiary.

To the extent that any amount paid, credited, or to be distributed by an estate or trust in the first taxable year of such estate or trust to which this part applies would be treated, if the Internal Revenue Code of 1939 were applicable, as paid, credited, or to be distributed on the last day of the preceding taxable year, such amount shall not be taken into account for purposes of this part but shall be taken into account as provided in the Internal Revenue Code of 1939.

§1.683–1 APPLICABILITY OF PROVISIONS; GENERAL RULE.—Sections 641 through 683 apply to estates and trusts and to beneficiaries only with respect to taxable years which begin after December 31, 1953, and end after August 16, 1954, the date of enactment of the Internal Revenue Code of 1954. In the case of an estate or trust, the date on which a trust is created or amended or on which an estate commences, and the taxable years of beneficiaries, grantors, or decedents concerned, are immaterial. This provision applies equally to taxable years of normal and of abbreviated length.

§ 1.683–2 EXCEPTIONS.—(a) In the case of any beneficiary of an estate or trust, sections 641 through 682 do not apply to any amount paid, credited, or to be distributed by an estate or trust in any taxable year of the estate or trust which begins before January 1, 1954, or which ends before August 17, 1954. Whether an amount so paid, credited, or to be distributed is to be included in the gross income of a beneficiary is determined with reference to the Internal Revenue Code of 1939. Thus, if a trust in its fiscal year ending June 30, 1954, distributed its current income to a beneficiary on June 30, 1954, the extent to which the distribution is includible in the beneficiary's gross income for his taxable year (the calendar year 1954) and the character of such income will be determined under the Internal Revenue Code of 1939. The Internal Revenue Code of 1954, however, determines the beneficiary's tax liability for a taxable year of the beneficiary to which such Code applies, with respect even to gross income of the beneficiary determined under the Internal Revenue Code of 1939 in accordance with this paragraph. Accordingly, the beneficiary is allowed credits and deductions pursuant to the Internal Revenue Code of 1954 for a taxable year governed by the Internal Revenue Code of 1954. See subparagraph (2) of example (1) in paragraph (c) of this section.

(b) For purposes of determining the time of receipt of dividends under sections 34 and 116, the dividends paid, credited, or to be distributed to a beneficiary are deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

(c) The application of this section may be illustrated by the following examples:

Example (1). (i) A trust, reporting on the fiscal year basis, receives in its taxable year ending November 30, 1954, dividends on December 3, 1953, and April 3, July 5, and October 4, 1954. It distributes the dividends to A, its sole beneficiary (who reports on the calendar year basis) on November 30, 1954. Since the trust has received dividends in a taxable year ending after July 31, 1954, it will receive a dividend credit under section 34 with respect to dividends received which otherwise qualify under that section, in this case dividends received on October 4, 1954 (i. e., received after July 31, 1954). See section 7851(a)(1)(C). This credit, however, is reduced to the extent the dividends are allocable to the beneficiary as a result of income being paid, credited, or required to be distributed to him. The trust will also be permitted the dividend exclusion under section 116, since it received its dividends in a taxable year ending after July 31, 1954.

(ii) A is entitled to the section 34 credit with repsect to the portion of the October 4, 1954, dividends which is distributed to him even though the determination of whether the amount distributed to him is includible in his gross income is made under the 1939 Code. The credit allowable to the trust is reduced proportionately to the extent A is deemed to have received the October 4 dividends. A is not entitled to a credit with respect to the dividends received by the trust on December 3, 1953, and April 3, and July 5, 1954, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust on dates prior to July 31, 1954. In determining the exclusion under section 116 to which he is entitled, all the dividends received by the trust in 1954 and distributed to him are aggregated with any other dividends received by him in 1954, since he is deemed to have received such dividends in 1954 and thereafter within a taxable year ending after July 31, 1954. He is not, however, entitled to the exclusion for the dividends received by the trust in December 1953.

Example (2). (i) A simple trust reports on the basis of a fiscal year ending July 31. It receives dividends on October 3, 1953, and January 4, April 3, and July 5, 1954. It distributes the dividends to A, its sole beneficiary, on September 1, 1954. The trust, receiving dividends in a taxable year ending prior to August 17, 1954, is entitled neither to the dividend received credit under section 34 nor the dividend exclusion under section 116.

(ii) A (reporting on the calendar year basis) is not entitled to the section 34 credit, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust, that is, on October 3, 1953, and January 4, April 3, and July 5, 1954. He is, however, entitled to the section 116 exclusion with respect to the dividends received by the trust in 1954 (along with other dividends received by him in 1954) and distributed to him, since he is deemed to have received such dividends on January 4, April 3, and

July 5, 1954, each a date in his taxable year ending after July 31, 1954. He is entitled to no exclusion for the dividends received by the trust on October 3, 1953, since he is deemed to receive the resulting distribution on the same date, which falls within a taxable year of his which ends before August 1, 1954, although he is required to include the October 1953 dividends in his 1954 income. See section 164 of the Internal Revenue Code of 1939.

Example (3). A simple trust on a fiscal year ending July 31, 1954, receives dividends August 5 and November 4, 1953. It distributes the dividends to A, its sole beneficiary (who is on a calendar year basis), on September 1, 1954. Neither the trust nor A is entitled to a credit under section 34 or an exclusion under section 116.

§ 1.683–3 Application of the 65-Day Rule of the Internal Revenue Code of 1939.—If an amount is paid, credited, or to be distributed in the first 65 days of the first taxable year of an estate or trust (heretofore subject to the provisions of the Internal Revenue Code of 1939) to which the Internal Revenue Code of 1954 applies and the amount would be treated, if the Internal Revenue Code of 1939 were applicable, as if paid, credited, or to be distributed on the last day of the preceding taxable year, sections 641 through 682 do not apply to the amount. The amount so paid, credited, or to be distributed is taken into account as provided in the Internal Revenue Code of 1939. See § 39.162–2(c) and (d) of Regulations 118 (26 CFR (1939) 39.162–2(c) and (d)).

Partners and Partnerships

DEFINITIONS

§ 1.761–1 Terms Defined.—(a) *Partnership.*—(1) *In general.*—

[Subparagraph (2) of § 1.761–1(a) as set forth in the previously issued pamphlet in this series (Publication No. 329–1) was deleted by T. D. 6198 and the following provisions inserted in lieu thereof.]

(2) *Exclusion of certain partnerships from provisions of subchapter K.*—(i) *In general.*—Under conditions set forth in this paragraph, an unincorporated organization described in subdivision (ii) or (iii) of this subparagraph may be excluded from the application of all or a part of the provisions of subchapter K. Such organization must be availed of for investment purposes only and not for the active conduct of a business, or for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(ii) *Investing partnership.*—Where the participants in the joint purchase, retention, sale, or exchange of investment property—

(*a*) Own the property as coowners,

(*b*) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(*c*) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in subdivision (iv) of this subparagraph.

(iii) *Operating agreements.*—Where the participants in the joint production, extraction, or use of property—

(*a*) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(*b*) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(*c*) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in subdivision (iv) of this subparagraph. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

(iv) *Method of election.*—(*a*) *Complete exclusion from subchapter K.*—Any unincorporated organization described in subdivisions (i) and (ii) or (iii) of this subparagraph which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) in a statement attached to a properly executed partnership return, Form 1065, which shall contain the information required in this subdivision. Such return shall be filed with the district director for the district in which the organization has its principal office or place of business. For the purpose of determining the district in which the organization has its principal office or place of business, the principal office or place of business of the operator shall be considered the principal office or place of business of the organization, unless the person filing for the organization is not the operator, in which case, the principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. For the first year with respect to which such unincorporated organization wishes to be excluded from subchapter K, its partnership return shall contain, in lieu of the information required by Form 1065 and by the instructions relating thereto, only the name or other identification and the address of the organization. The statement attached to the return shall include the names and addresses of all the members of the organization; a statement that the organization qualifies under subdivisions (i) and either (ii) or (iii) of this subparagraph, a statement that all of the members of the organization elect that it be ex-

cluded from all of subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained). Unless within 90 days after the formation of the organization (or by October 15, 1956, whichever is later) any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail, the election to be excluded will be effective. Such election is irrevocable as long as the organization remains qualified under subdivisions (i) and either (ii) or (iii) of this subparagraph, or unless approval of revocation of the election is secured from the Commissioner. Application for permission to revoke the election must be submitted to the Commissioner of Internal Revenue, Attention: T: R, Washington, D. C., no later than 30 days after the beginning of the first taxable year to which the revocation is to apply. An unincorporated organization need not file an election to be excluded under section 761 for the first year of its existence but may do so at the time of filing the return for any taxable year for which exclusion from subchapter K is desired. Such unincorporated organization shall file a partnership return for the first taxable year in which the participants by a formal agreement undertake to engage in joint operations, or in the absence of a formal agreement for the first taxable year in which the participants with respect to the joint use of property jointly make or incur any expenditures treated as deductions for Federal income tax purposes, whether or not electing to be excluded from the provisions of subchapter K. Where no annual accounting period has been adopted by such unincorporated organization, its taxable year shall be the calendar year in accordance with section 441(g).

(*b*) *Partial exclusion from subchapter K.*—An unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under subdivisions (i) and either (ii) or (iii) of this subparagrph, and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(v) *Information to be filed by organizations excluded under section 761.*—(*a*) An organization which elects under subdivision (iv) (*a*) of this subparagraph to be excluded from all of subchapter K shall file the following:

(*1*) For the first taxable year for which it wishes to be excluded: a partnership return, as provided in subdivision (iv) (*a*) of this subparagraph;

(*2*) For each subsequent taxable year for which it is excluded: Form 1096 for the organization and a Form 1099 for each person

who was a member of the organization during any part of the calendar year. Form 1099 shall show the name and address of the organization (under "By Whom Paid"). In lieu of "Kind and Amount of Income Paid," each Form 1099 shall state "Filed under section 761(a)" and the principal activity of the organization. Forms 1096 and 1099 shall be filed with the Commissioner of Internal Revenue, Midwest Service Center, Kansas City, Missouri.

(*b*) Organizations partially excluded from subchapter K shall file partnership returns containing such information as the Commissioner may require upon the granting of the partial exclusion under section 761(a).

Insurance Companies

LIFE INSURANCE COMPANIES

§ 1.801 Statutory Provisions; Life Insurance Companies; Definition of Life Insurance Company.

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if its life insurance reserves (as defined in section 803(b)), plus unearned premiums and unpaid losses on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves. For purposes of this section, the term "total reserves" means life insurance reserves, unearned premiums and unpaid losses not included in life insurance reserves, and all other insurance reserves required by law. A burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under section 802 but shall be taxable under section 821 or section 831.

§ 1.801-1 Definitions.—(a) *Life insurance company.*—The term "life insurance company" as used in subtitle A is defined in section 801. For the purpose of determining whether a company is a "life insurance company" within the meaning of that term as used in section 801, it must first be determined whether the company is taxable as an insurance company under the Internal Revenue Code. For the definition of an "insurance company," see paragraph (b) of this section. In determining whether an insurance company is a life insurance company, the life insurance reserves (as defined in section 803(b)) plus any unearned premiums and unpaid losses on noncancellable life, health, or accident policies, not included in "life insurance reserves" must comprise more than 50 percent of its total reserves (as defined in section 801). An insurance company writing only noncancellable life, health, or accident policies and having no "life insurance reserves" may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancellable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. For the purpose of the preceding sentence, the

term "unearned premium" means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance. A burial or funeral benefit insurance company qualifying as a life insuance company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 821 or section 831 as an insurance company other than life.

(b) *Insurance companies.*—(1) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the funds for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

(2) Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Internal Revenue Code. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954 within the meaning of the Code and the regulations thereunder.

§ 1.802(b) Statutory Provisions; Life Insurance Companies; Imposition of Tax.

SEC. 802. IMPOSITION OF TAX. * * *

(b) Taxable Years Beginning in 1954.—In lieu of the tax imposed by subsection (a) there shall be imposed, for taxable years beginning in 1954, on the 1954 life insurance company taxable income (as defined in section 805) of every life insurance company a tax equal to the sum of the following:

(1) 3¾ percent of the amount thereof not in excess of $200,000, plus

(2) 6½ percent of the amount thereof in excess of $200,000.

§ 1.802(b)-1 Tax on Life Insurance Companies.—(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, section 802(b) imposes a tax on the 1954 life insurance company taxable income of all life insurance companies (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801). The tax so imposed is equal to 3¾ percent of the amount of such income not in excess of $200,000, plus 6½ percent of the amount of such income in excess of $200,000. For the definition of the term "1954 life insurance company taxable income," see § 1.805-1.

(b) The taxable income of life insurance companies differs from the taxable income of other corporations. See section 803. Life insurance companies are entitled, in computing life insurance company taxable income, to the special deductions provided in part VIII of subchapter B (except section 248). The gross income, the deduction under section 803(g)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 803(i) and § 1.803–6. Such companies are not subject to the provisions of subchapter P (section 1201 and following, relating to capital gains and losses) nor to the provisions of section 171 (amortizable bond premium).

(c) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of sections 801 to 807, inclusive, are applicable to the assessment and collection of the tax imposed by section 802, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(d) Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

§ 1.803 Statutory Provisions: Life Insurance Companies; Other Definitions and Rules.

SEC. 803. OTHER DEFINITIONS AND RULES.

(a) Application of Section; Gross Income.—

(1) Application.—The definitions and rules contained in this section shall apply only in the case of life insurance companies.

(2) Gross income.—The term "gross income" means the gross amount of income received or accrued during the taxable year from interest, dividends, and rents.

(b) Life Insurance Reserves.—The term "life insurance reserves" means amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Such life insurance reserves, except in the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation and except as hereinafter provided in the case of assessment life insurance, must also be required by law. In the case of an assessment life insurance company or association, the term "life insurance reserves" includes sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained, under the charter or articles of incorporation or association (or bylaws approved by a State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued on the assessment plan and not subject to any other use.

(c) Adjusted Reserves.—The term "adjusted reserves" means life insur-

ance reserves plus 7 percent of that portion of such reserves as are computed on a preliminary term basis.

* * * * * * *

(e) RESERVE FOR DEFERRED DIVIDENDS.—The term "reserve for deferred dividends" means sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than 5 years from the date of the policy contract.

(f) INTEREST PAID.—The term "interest paid" means—

(1) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this chapter, and

(2) All amounts in the nature of interest, whether or not guaranteed, paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve, at the time of payment or accrual, life, health, or accident contingencies.

(g) TAXABLE INCOME.—The term "taxable income" means the gross income less the following deductions:

(1) TAX-FREE INTEREST.—The amount of interest received or accrued during the taxable year which under section 103 is excluded from gross income.

(2) INVESTMENT EXPENSES.—Investment expenses paid or incurred during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which taxable income (computed without any deduction for investment expenses allowed by this paragraph, for tax-free interest allowed by paragraph (1), or for partially tax-exempt interest and dividends received allowed by paragraph (5)) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(3) REAL ESTATE EXPENSES.—Taxes and other expenses paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed on a shareholder of a company on his interest as shareholder, which are paid or accrued by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(4) DEPRECIATION.—The depreciation deduction allowed by section 167.

(5) SPECIAL DEDUCTIONS.—The special deductions allowed by part VIII of subchapter B (except section 248).

(h) RENTAL VALUE OF REAL ESTATE.—The deduction under subsection (g)(3) and (4) on account of any real estate owned and occupied in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this subsection) as the rental value of the space not so occupied bears to the rental value of the entire property.

(i) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—The gross income, the deduction provided in subsection (g)(1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined—

(1) in accordance with the method regularly employed by such company, if such method is reasonable, and

(2) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(j) DOUBLE DEDUCTIONS.—Nothing in this part shall permit the same item to be deducted more than once.

§ 1.803–1 LIFE INSURANCE RESERVES.—(a) The term "life insurance reserves" is defined in section 803(b). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancellable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation or association of such company or association, or bylaws (approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(c) Life insurance reserves, except as otherwise provided in section 803(b), must be required by law either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, life insurance reserves do not include reserves required to be maintained to provide for the ordinary running expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit at interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health or accident contingencies.

(d) In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 803(b), be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any

State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized mortality or morbidity tables covering disability benefits of the kind contained in policies issued by this particular class of companies but they need not be required by law.

§ 1.803–2 Adjusted Reserves.—For the purpose of determining "required interest" for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by seven percent. The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves as thus adjusted, and the rate of interest on which they are computed, should be reported in Schedule A, Form 1120L.

§ 1.803–3 Interest Paid or Accrued.—Interest paid or accrued is one of the elements to be used in computing the amount of "required interest" for purposes of determining the reserve interest credit provided in section 805. See § 1.805–1. Interest paid or accrued consists of (a) interest paid or accrued on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 803(f)(1)) and (b) amounts in the nature of interest paid or accrued on certain contracts, as provided in section 803(f)(2). Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid or accrued on deferred dividends. Life insurance reserves as defined in § 1.803–1 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which, at the time of payment, do not involve life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment, and the full amount of the interest paid or accrued and not merely the guaranteed interest is considered as interest paid or accrued.

§ 1.803–4 Taxable Income and Deductions.—(a) *In general.*—The taxable income of a life insurance company is its gross amount of income received or accrued during the taxable year from interest, dividends, and rents, less the deductions provided in section 803(g) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, and the special deductions provided in part VIII of subchapter B (except section 248). In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 803(h), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 803(i), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 803(g)(2), life insurance companies are subject to the limitations on deductions relating to wholly tax-exempt income provided in section 265. Life insurance companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.*—Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross income of a life insurance company by section 803(a)(2) is allowed as a deduction from gross income by section 803(g)(1).

(c) *Investment expenses.*—(1) As used in the Internal Revenue Code, the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 803(g)(2) subjects the entire deduction for investment expenses to the limitation provided in that section. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses paid or incurred during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

(3) Invested assets for the purpose of section 803(g)(2) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2). They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses, the maximum allowance will not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses.

(d) *Taxes and expenses with respect to real estate.*—The deduction for taxes and expenses under section 803(g)(3) includes taxes and expenses paid or accrued during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid or accrued by the company without reimbursement from the shareholder. No deduction shall

be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. See paragraph (c) of this section. As to real estate owned and occupied by the company, see § 1.803–5.

(e) *Depreciation.*—The deduction allowed for depreciation is, except as provided in section 803(h), identical with that allowed other corporations by section 167. The amount allowed by section 167 in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2).

§ 1.803–5 REAL ESTATE OWNED AND OCCUPIED.—The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

§ 1.803–6 AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—(a) Section 803(i) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the deduction for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable

at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined—

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section: and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

§ 1.805 Statutory Provisions; Life Insurance Companies; Life Insurance Company Taxable Income.

SEC. 805. 1954 LIFE INSURANCE COMPANY TAXABLE INCOME.

(a) Definition.—For purposes of section 802(b), the term "1954 life insurance company taxable income" means the taxable income (as defined in section 803(g)), plus 8 times the amount of the adjustment for certain reserves provided in section 806, and minus the reserve interest credit, if any, provided in subsection (b) of this section.

(b) Reserve Interest Credit.—For purposes of subsection (a), the reserve interest credit shall be an amount determined as follows:

(1) Divide the amount of the adjusted taxable income (as defined in subsection (c) by the amount of the required interest (as defined in subsection (d)).

(2) If the quotient obtained in paragraph (1) is 1.05 or more, the reserve interest credit shall be zero.

(3) If the quotient obtained in paragraph (1) is 1.00 or less, the reserve interest credit shall be an amount equal to 50 percent of the taxable income.

(4) If the quotient obtained in paragraph (1) is more than 1.00 but less than 1.05, the reserve interest credit shall be the amount obtained by multiplying the taxable income by 10 times the difference between the figures 1.05 and such quotient.

(c) ADJUSTED TAXABLE INCOME.—For purposes of subsection (b)(1), the term "adjusted taxable income" means the taxable income (computed without the deductions provided in section 803(g)(1) or (5)) minus 50 percent of the amount of the adjustment for certain reserves provided in section 806.

(d) REQUIRED INTEREST.—For purposes of subsection (b)(1), the term "required interest" means the total of—

(1) the sum of the amounts obtained by multiplying—

(A) each rate of interest assumed in computing the taxpayer's life insurance reserves by

(B) the means of the amounts of the taxpayer's adjusted reserves computed at that rate at the beginning and end of the taxable year,

(2) 2 percent of the reserve for deferred dividends, and

(3) interest paid.

§ 1.805–1 TAX ON LIFE INSURANCE COMPANIES IN THE CASE OF A TAXABLE YEAR BEGINNING IN 1954.—(a) Section 802(b) imposes a tax on the "1954 life insurance company taxable income" of all life insurance companies for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954. See paragraph (a) of § 1.802(b)–1.

(b) For purposes of section 802(b), the term "1954 life insurance company taxable income" means the taxable income (consisting of income computed as provided in § 1.803–4) for the taxable year beginning in 1954 plus eight times the amount of the adjustment for certain reserves computed as provided in section 806 (see § 1.806–1), and minus the reserve interest credit, if any, provided in section 805(b) (see § 1.805–2).

§ 1.805–2 RESERVE INTEREST CREDIT.—(a) In computing 1954 life insurance company taxable income, a reserve interest credit is allowed where the "adjusted taxable income" of the company is less than 105 percent of its required interest. For the purpose of computing the reserve interest credit, the term "adjusted taxable income" means the taxable income of the company computed without the deductions provided in section 803(g)(1) or (5), less 50 percent of the adjustment for certain reserves on contracts other than life insurance or annuity contracts provided in section 806.

(b) The required interest for which a credit may be allowed consists of the total of—

(1) The sum of amounts obtained by multiplying each rate of interest assumed in computing life insurance reserves (see section 803(b) and § 1.803–1) by the means of the amounts of the adjusted reserves, as defined in section 803(c), computed at that rate at the beginning and the end of the taxable year;

(2) Two percent of the reserve for deferred dividends; and

(3) Interest paid or accrued.

(c) To determine the amount of the reserve interest credit, it is necessary to divide the amount of the adjusted taxable income by the

amount of the required interest. If the adjusted taxable income is 100 percent or less of the required interest, the reserve interest credit is an amount equal to 50 percent of the life insurance company taxable income. If the adjusted taxable income is 105 percent or more of the required interest, the reserve interest credit is zero. If the adjusted taxable income is more than 100 percent and less than 105 percent of the required interest, the reserve interest credit is computed by multiplying the life insurance company taxable income by ten times the difference between 105 percent and the percentage established. Thus, if the adjusted taxable income of a life insurance company for the calendar year 1954 is $103,000 and the required interest for such year is $100,000, the adjusted taxable income is 103 percent of the required interest and the reserve interest, accordingly, is the life insurance company taxable income multiplied by 20 percent (10 times 2 percent, the difference between 105 percent and 103 percent).

(d) In determining the percentage of the adjusted taxable income to required interest for purposes of determining the reserve interest credit, the figures shall be computed to at least the nearest one-tenth of a percentage point.

§ 1.806 STATUTORY PROVISIONS; LIFE INSURANCE COMPANIES; ADJUSTMENT FOR CERTAIN RESERVES.

SEC. 806. ADJUSTMENT FOR CERTAIN RESERVES.

In the case of a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means an amount equal to 3¼ percent of the unearned premiums and unpaid losses on such other contracts which are not included in life insurance reserves (as defined in section 803(b). For purposes of this section, such unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such other contracts.

§ 1.806–1 ADJUSTMENT FOR CERTAIN RESERVES.—(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its life insurance company taxable income (as a factor in determining 1954 adjusted taxable income) an amount equal to eight times the amount of the adjustment for certain reserves provided in paragraph (b) of this section.

(b) The adjustment for certain reserves referred to in paragraph (a) of this section shall be an amount equal to 3¼ percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the adjustment shall be 3¼ percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3¼ percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. As used in this section, the term "unearned premiums" has the same meaning as in section 832(b) (4) and § 1.832–1.

§ 1.807 Statutory Provisions; Life Insurance Companies; Foreign Life Insurance Companies.

SEC. 807. FOREIGN LIFE INSURANCE COMPANIES.

(a) Carrying on United States Insurance Business.—A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable in the same manner as a domestic life insurance company; except that the determinations necessary for purposes of this subtitle shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Insurance Commissioners.

(b) No United States Insurance Business.—Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under this section but shall be taxable as other foreign corporations.

§ 1.807–1 Foreign Life Insurance Companies.—A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, is taxable on its income received during the taxable year from interest, dividends, and rents, from sources within and without the United States, pertaining to its United States business. Such a company is taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of subtitle A, such as gross income, the adjustment for certain reserves, deductions and limitations on deductions, amortization of premiums and accrual of discount, and the deductions allowed the company in part VIII of subchapter B, shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Life Insurance Commissioners. This statement is presumed to reflect the income, disbursements, assets, and liabilities of the United States business of the company and insofar as it is not inconsistent with the provisions of the Internal Revenue Code will be recognized and used as a basis for that purpose.

MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES)

§ 1.821 Statutory Provisions; Tax on Mutual Insurance Companies (Other Than Life or Marine or Fire Insurance Companies Issuing Perpetual Policies).

SEC. 821. TAX ON MUTUAL INSURANCE COMPANIES (OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES).

(a) Imposition of Tax on Mutual Companies Other Than Interinsurers.—There shall be imposed for each taxable year on the income of every mutual insurance company (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 831 and other than an interinsurer or reciprocal underwriter) a tax computed under paragraph (1) or paragraph (2), whichever is the greater:

(1) If the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) is over $3,000, a tax computed as follows:

(A) NORMAL TAX.—

(i) TAXABLE YEARS BEGINNING BEFORE APRIL 1, 1955.—In the case of taxable years beginning before April 1, 1955, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $3,000, whichever is the lesser;

* * * * * * *

(B) SURTAX.—A surtax of 22 percent of the mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000.

(2) If for the taxable year the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders, minus the interest which under section 103 is excluded from gross income, exceeds $75,000, a tax equal to 1 percent of the amount so computed, or 2 percent of the excess of the amount so computed over $75,000, whichever is the lesser.

(b) IMPOSITION OF TAX ON INTERINSURERS.—In the case of every mutual insurance company which is an interinsurer or reciprocal underwriter (other than a life or a marine insurance company or a fire insurance company subject to the tax imposed by section 831), if the mutual insurance company taxable income (computed as provided in subsection (a)(1)) is over $50,000, there shall be imposed for each taxable year on the mutual insurance company taxable income a tax computed as follows:

(1) NORMAL TAX.—

(A) TAXABLE YEARS BEGINNING BOFORE APRIL 1, 1955.—In the case of taxable years beginning before April 1, 1955, a normal tax of 30 percent of the mutual insurance company taxable income, or 60 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser;

* * * * * * *

(2) SURTAX.—A surtax of 22 percent of the mutual insurance company taxable income (computed as provided in subsection (a)(1)) in excess of $25,000, or 33 percent of the amount by which such taxable income exceeds $50,000, whichever is the lesser.

(c) GROSS AMOUNT RECEIVED, OVER $75,000 BUT LESS THAN $125,000.—If the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 but less than $125,000, the tax imposed by subsection (a) or subsection (b), whichever applies, shall be reduced to an amount which bears the same proportion to the amount of the tax determined under such subsection as the excess over $75,000 of such gross amount received bears to $50,000.

(d) NO UNITED STATES INSURANCE BUSINESS.—Foreign mutual insurance companies (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States shall not be subject to this part but shall be taxable as other foreign corporations.

(e) ALTERNATIVE TAX ON CAPITAL GAINS.—For alternative tax in case of capital gains, see section 1201(a).

§ 1.821–1 TAX ON MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE OR FIRE INSURANCE COMPANIES SUBJECT TO THE TAX IMPOSED BY SECTION 831.—(a) *In general.*—(1) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 801 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax

imposed by section 821(a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII of subchapter B (except section 248). The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and § 1.822-3.

(3) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821(a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821(a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income from interest, dividends, rents, and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) *Rates of tax.*—(1) The normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums,

minus dividends to policyholders and minus wholly tax-exempt interest.

(3) Under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) Under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable year from interest dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) *Application.*—The application of sections 821(a) to (c) inclusive, may be illustrated by the following examples:

Example (1). The W Company, a mutual casualty insurance company, for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from interest, dividends, rents and net premiums, minus dividends to policy holders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1954 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1954 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000−$75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example (2). If in the above example the income for pur-

poses of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, were $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example (3). The X Company, a mutual casualty insurance company, for the calendar year 1954 has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1954 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000−$25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example (4). The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received from interest, dividends, rents and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $10,080.

Example (5). The Z Exchange, an interinsurer, for the calendar year 1954 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar year 1954 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(a) is $3,300.

§ 1.822 STATUTORY PROVISIONS; DETERMINATION OF MUTUAL INSURANCE COMPANY TAXABLE INCOME.

SEC. 822. DETERMINATION OF MUTUAL INSURANCE COMPANY TAXABLE INCOME.

(a) DEFINITION.—For purposes of section 821, the term "mutual insurance company taxable income" means the gross investment income minus the deductions provided in subsection (c).

(b) GROSS INVESTMENT INCOME.—For purposes of subsection (a), the term "gross investment income" means the gross amount of income during the taxable year from interest, devidends, rents, and gains from sales or exchanges of capital assets to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses).

(c) DEDUCTIONS.—In computing mutual insurance company taxable income, the following deductions shall be allowed:

(1) TAX-FREE INTEREST.—The amount of interest which under section 103 is excluded for the taxable year from gross income.

(2) INVESTMENT EXPENSES.—Investment expenses paid or accrued during the taxable year. If any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year plus one-fourth of the amount by which mutual insurance company taxable income (computed without any deduction for investment expenses allowed by this paragraph, for tax-free interest allowed by paragraph (1), or for partially tax-exempt interest and dividends received allowed by paragraph (7)), exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

(3) REAL ESTATE EXPENSES.—Taxes and other expenses paid or accrued during the taxable year exclusively on or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed on a shareholder of a company on his interest as shareholder, which are paid or accrued by the company without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(4) DEPRECIATION.—The depreciation deduction allowed by section 167.

(5) INTEREST PAID OR ACCRUED.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or con-

tinued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest on which is wholly exempt from taxation under this subtitle.

(6) CAPITAL LOSSES.—Capital losses to the extent provided in subchapter P (sec. 1201 and following) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 1211 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) the mutual insurance company taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deduction provided in section 242 for partially tax-exempt interest); or

(B) losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders.

(7) SPECIAL DEDUCTIONS.—The special deductions allowed by part VIII (except section 248) of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

(d) OTHER APPLICABLE RULES.—

(1) RENTAL VALUE OF REAL ESTATE.—The deduction under subsection (e)(3) or (4) on account of any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 shall be limited to an amount which bears the same ratio to such deductions (computed without regard to this paragraph) as the rental value of the space not so occupied bears to the rental value of the entire property.

(2) AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—The gross amount of income during the taxable year from interest, the deduction provided in subsection (c)(1), and the deduction allowed by section 242 (relating to partially tax-exempt interest) shall each be decreased to reflect the appropriate amortization of premium and increased to reflect the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual shall be determined—

(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

(B) in all other cases, in accordance with regulations prescribed by the Secretary or his delegate.

(3) DOUBLE DEDUCTIONS.—Nothing in this part shall permit the same item to be deducted more than once.

(e) FOREIGN MUTUAL INSURANCE COMPANIES OTHER THAN LIFE OR MARINE.—In the case of a foreign mutual insurance company (other than a life or marine insurance company or a fire insurance company subject to the tax imposed by section 831), the mutual insurance company taxable income shall be the taxable income from sources within the United States (computed without regard to the deductions allowed by subsection (c)(7)), and the gross amount of income from the interest, dividends, rents, and net premiums shall be the amount of such income from sources within the United States. In the case of a company to which the preceding sentence applies, the deductions allowed in this section shall be allowed to the extent provided in

subpart B of part II of subchapter N (sec. 881 and following) in the case of a foreign corporation engaged in trade or business within the United States.

§ 1.822–1 TAXABLE INCOME AND DEDUCTIONS.—(a) *In general.*—For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, the taxable income of a mutual insurance company subject to the tax imposed by section 821 is its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets, less the deductions provided in section 822(c) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accured, capital losses to the extent provided in subchapter P (sec. 1201 and following), and the special deductions provided in part VIII of subchapter B (except section 248). In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accural of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172.

(b) *Wholly tax-exempt interest.*—Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(c) *Investment expenses.*—The deduction allowed by section 822(c)(2) for investment expenses is the same as that allowed life insurance companies by section 803(g)(2). See paragraph (c) of § 1.803–4.

(d) *Taxes and expenses with respect to real estate.*—The deduction allowed by section 822(c)(3) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 803(g)(3). See paragraph (d) of § 1.803–4.

(e) *Depreciation.*—The deduction allowed by section 822(c)(4) for depreciation is the same as that allowed life insurance companies by section 803(g)(4). See paragraph (e) of § 1.803–4.

(f) *Interest paid or accrued.*—The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(g) *Capital losses.*—(1) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(2) Capital assets are considered as sold or exchanged to provide

for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(3) The application of section 822(c)(6) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1954 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example (2). If in the above example the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example (3). If in example (1) the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1954, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange

of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(h) *Special deductions.*—Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (except section 248) of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

§ 1.822–2 REAL ESTATE OWNED AND OCCUPIED.—The limitation in section 822(d)(1) on the amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 is the same as that provided in the case of life insurance companies by section 803(h). See § 1.803–5.

§ 1.822–3 AMORTIZATION OF PREMIUM AND ACCRUAL OF DISCOUNT.—Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 803(i) and shall be determined in accordance with § 1.803–6, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 821 the basis provided in section 1012 shall be used in lieu of the acquisition value.

§ 1.823 STATUTORY PROVISIONS; OTHER DEFINITIONS.

SEC. 823. OTHER DEFINITIONS.

For purposes of this part—

(1) NET PREMIUMS.—The term "net premiums" means gross premiums (including deposits and assessments) written or received on insurance contracts during the taxable year less return premiums and premiums paid or incurred for reinsurance. Amounts returned where the amount is not fixed in the insurance contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums but shall be treated as dividends to policyholders under paragraph (2).

(2) DIVIDENDS TO POLICYHOLDERS.—The term "dividends to policyholders" means dividends and similar distributions paid or declared to policyholders. For purposes of the preceding sentence, the term "paid or declared" shall be constructed according to the method regularly employed in keeping the books of the insurance company.

§ 1.823–1 NET PREMIUMS.—Net premiums are one of the items used, together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the applica-

tion of section 1212. The term "net premiums" is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

§ 1.823–2 Dividends to Policyholders.—(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "dividends to policyholders" is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return permiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policy holders by factory mutual fire insurance companies. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

> To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

OTHER INSURANCE COMPANIES

§ 1.831 Statutory Provisions; Tax on Insurance Companies (Other Than Life or Mutual), Mutual Marine Insurance Companies, and Mutual Fire Insurance Companies Issuing Perpetual Policies.

SEC. 831. TAX ON INSURANCE COMPANIES (OTHER THAN LIFE OR MUTUAL), MUTUAL MARINE INSURANCE COMPANIES, AND MUTUAL FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES.

(a) Imposition of Tax.—Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance

company (other than a life or mutual insurance company), every mutual marine insurance company, and every mutual fire insurance company exclusively issuing either perpetual policies or policies for which the sole premium charged is a single deposit which (except for such deduction of underwriting costs as may be provided) is refundable on cancellation or expiration of the policy.

(b) NO UNITED STATES INSURANCE BUSINESS.—Foreign insurance companies (other than a life or mutual insurance company), foreign mutual marine insurance companies, and foreign mutual fire insurance companies described in subsection (a), not carrying on an insurance business within the United States, shall not be subject to this part but shall be taxable as other foreign corporations.

(c) ALTERNATIVE TAX ON CAPITAL GAINS.—For alternative tax in case of capital gains, see section 1201(a).

§1.831-1 TAX ON INSURANCE COMPANIES (OTHER THAN LIFE OR MUTUAL), MUTUAL MARINE INSURANCE COMPANIES, AND MUTUAL FIRE INSURANCE COMPANIES ISSUING PERPETUAL POLICIES.—(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 831. As used in this section and §§ 1.832-1 and 1.832-2, the term "insurance companies" means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of § 1.801-1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII of subchapter B.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

§ 1.832 Statutory Provisions; Insurance Company Taxable Income.

SEC. 832. INSURANCE COMPANY TAXABLE INCOME.

(a) Definition of Taxable Income.—In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c).

(b) Definitions.—In the case of an insurance company subject to the tax imposed by section 831—

(1) Gross income.—The term "gross income" means the sum of—

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners,

(B) gain during the taxable year from the sale or other disposition of property, and

(C) all other items constituting gross income under subchapter B, except that, in the case of a mutual fire insurance company described in section 831(a), the amount of single deposit premiums paid to such company shall not be included in gross income.

(2) Investment income.—The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows: To all interest, dividends, and rents received during the taxable year, add interest, dividends, and rents due and accrued at the end of the taxable year, and deduct all interest, dividends, and rents due and accrued at the end of the preceding taxable year.

(3) Underwriting income.—The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

(4) Premiums earned.—The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the result so obtained, add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year.

For purposes of this subsection, unearned premiums shall include life insurance reserves, as defined in section 806, pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801.

(5) Losses incurred.—The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

(6) Expenses incurred.—The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted

from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

(c) DEDUCTIONS ALLOWED.—In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

(1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses);

(2) all interest, as provided in section 163;

(3) taxes, as provided in section 164;

(4) losses incurred, as defined in subsection (b) (5) of this section;

(5) capital losses to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders in their capacity as such, losses paid, and expenses paid over the sum of interest, dividends, rents, and net premiums received. In the application of section 1211 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) the taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deductions provided in section 242 for partially tax-exempt interest); or

(B) losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders;

(6) debts in the nature of agency balances and bills receivable which became worthless within the taxable year;

(7) the amount of interest earned during the taxable year which under section 103 is excluded from gross income;

(8) the depreciation deduction allowed by section 167;

(9) charitable, etc., contributions, as provided in section 170;

(10) deductions (other than those specified in this subsection) as provided in part VI of subchapter B (sec. 161 and following, relating to itemized deductions for individuals and corporations);

(11) dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in section 831(a). For purposes of the preceding sentence, the term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company; and

(12) the special deductions allowed by part VIII of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received).

(d) TAXABLE INCOME OF FOREIGN INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL AND FOREIGN MUTUAL MARINE.—In the case of a foreign insurance company (other than a life or mutual insurance company), a foreign mutual marine insurance company, and a foreign mutual fire insurance company described in section 831(a), the taxable income shall be the taxable income from sources within the United States. In the case of a company to which the preceding sentence applies, the deductions allowed in this section shall be allowed to the extent provided in subpart B of part II of subchapter N (sec. 881 and following) in the case of a foreign corporation engaged in trade or business within the United States.

(e) DOUBLE DEDUCTIONS.—Nothing in this section shall permit the same item to be deducted more than once.

§ 1.832

§ 1.832–1 GROSS INCOME.—(a) Gross income as defined in section 832(b) (1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in § 1.831–1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Internal Revenue Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing "premiums earned on insurance contracts during the taxable year" the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 803(b) and § 1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801, and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums. In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deductions for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may

require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) That part of the deduction for "losses incurred" which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

§ 1.832–2 Deductions.—(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c) (10) and (12) include in addition certain deductions provided in sections 161, 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, "gross income" shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the 5-year capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821, see section 822(c)(6) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in § 1.831–1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821, see section 823(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the

year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

PROVISIONS OF GENERAL APPLICATION

§ 1.841 Statutory Provisions; Credit for Foreign Taxes.

SEC. 841. CREDIT FOR FOREIGN TAXES.

The taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section 802, 821, or 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). For purposes of the preceding sentence, the term "taxable income" as used in section 904 means—

(1) in the case of the tax imposed by section 802, the taxable income (as defined in section 803 (g)).

(2) in the case of the tax imposed by section 831, the taxable income (as defined in section 832(a)).

§ 1.842 Statutory Provisions; Computation of Gross Income.

SEC. 842. COMPUTATION OF GROSS INCOME.

The gross income of insurance companies subject to the tax imposed by section 802 or 831 shall not be determined in the manner provided in part I of subchapter N (relating to determination of sources of income).

Gain or Loss on Disposition of Property

BASIS RULES OF GENERAL APPLICATION

§ 1.1021 Statutory Provisions; Sale of Annuities.

SEC. 1021. SALE OF ANNUITIES.

In case of the sale of an annuity contract, the adjusted basis shall in no case be less than zero.

§ 1.1021–1 Sale of Annuities.—In the case of a transfer for value of an annuity contract to which section 72(g) and paragraph (a) of § 1.72–10 apply, the transferor shall adjust his basis in such contract as of the time immediately prior to such transfer by subtracting from the premiums or other consideration he has paid or is deemed to have paid for such contract all amounts he has received or is deemed to have received under such annuity contract to the extent that such amounts were not includible in the gross income of the transferor or other recipient under the applicable income tax law. In any case where the amounts which were not includible in the gross income of the recipient were received or deemed to have been received by such transferor exceed the amounts paid or deemed paid by him, the adjusted basis of the contract shall be zero. The income realized by the transferor on such a transfer shall not exceed the total of the amounts received as consideration for the transfer.

§ 1.1031(a) Statutory Provisions; Exchange of Property Held for Productive Use or Investment; Nonrecognition of Gain or Loss From Exchanges Solely in Kind.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT.

(a) Nonrecognition of Gain or Loss From Exchanges Solely in Kind.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

§ 1.1031(a)–1 Property Held for Productive Use in Trade or Business or for Investment.—(a) Section 1031(a) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. See section 1002 and the regulations thereunder. Under section 1031(a), no gain or loss is recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment. Under section 1031(a), property held for productive use in trade or business may be exchanged for property held for investment. Similarly, property held for investment may be exchanged for property held for productive use in trade or business. However, section 1031(a) provides that property held for productive use in trade or business or for investment does not include stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest. A transfer is not within the provisions of section 1031(a) if as part of the consideration the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b). Similarly, a transfer is not within the provisions of section 1031(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(b) As used in section 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other

than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

(c) No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, or (2) a real estate mortgage for consolidated farm loan bonds.

§ 1.1031(b) STATUTORY PROVISIONS; EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT; GAIN FROM EXCHANGES NOT SOLELY IN KIND.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT. * * *

(b) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—If an exchange would be within the provisions of subsection (a), of section 1035(a), or of section 1036(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

§ 1.1031(b)-1 RECEIPT OF OTHER PROPERTY OR MONEY IN TAX-FREE EXCHANGE.—(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money (1) in an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment, or (2) in an exchange described in section 1035(a) of insurance policies or annuity contracts, or (3) in an exchange described in section 1036 (a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, then—

(i) The gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but

(ii) The loss, if any, to the taxpayer from such an exchange will not be recognized to any extent (see section 1031 (c)).

(b) The application of this section may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for $5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of $6,000, and

$2,000 in cash. The gain from the transaction is $3,000, but is recognized only to the extent of the cash received of $2,000.

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as "other property or money" for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of "other property or money" for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See § 1.1031(d)-2, examples (1) and (2).

§ 1.1031(c) Statutory Provisions; Exchange of Property Held for Productive Use or Investment; Loss From Exchanges Not Solely in Kind.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT. * * *

(c) Loss From Exchanges Not Solely in Kind.—If an exchange would be within the provisions of subsection (a), of section 1035(a), or of section 1036(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

§ 1.1031(c)-1 Nonrecognition of Loss.—Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in sections 1031(a), 1035(a), or 1036(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss.

§ 1.1031(d) Statutory Provisions; Exchange of Property Held for Productive Use or Investment; Basis.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT. * * *

(d) Basis.—If property was acquired on an exchange described in this section, section 1035(a), or section 1036(a), then the basis shall be the same as that of the property exchanged decreased in the amount of any money received by the taxpayer and increased in the amount of gain to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), or section 1036(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall be considered as money received by the taxpayer on the exchange.

§ 1.1031(d)-1 Property Acquired Upon a Tax-Free Exchange.—(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), or section 1036(a), no part of the gain or loss was recognized under the law applicable to the year in which

the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), or section 1036(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of $2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of $2,400 and $200 in cash. A realizes a gain of $100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	$2,500
Less: Amount of money received	200
Difference	$2,300
Plus: Amount of gain recognized	100
Basis of truck acquired by A	$2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), or section 1036(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis to the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example. A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for $10,000 in exchange for other real estate (to be held for investment) which has a fair market value of $9,000, an automobile which has a fair market value of $2,000, and $1,500 in cash. A realizes a gain of $2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers ($10,000) decreased by the amount of money received ($1,500) and increased in the amount of gain that was recognized ($2,500), which results in a basis for the property received of $11,000. This basis of $11,000 is allocated between the automobile and the real estate received by A, the basis of the auto-

mobile being its fair market value at the date of the exchange, $2,000, and the basis of the real estate received being the remainder, $9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), or section 1036(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

§ 1.1031(d)–2 Treatment of Assumption of Liabilities.—For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example (1). B, an individual, owns an apartment house which has an adjusted basis in his hands of $500,000, but which is subject to a mortgage of $150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor $50,000 in cash and another apartment house with a fair market value on that date of $600,000. The transfer to C is made subject to the $150,000 mortgage. B realizes a gain of $300,000 on the exchange, computed as follows:

Value of property received	$600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	$800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	$300,000

Under section 1031(b), $200,000 of the $300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is $500,000, computed as follows:

Adjusted basis of property transferred		$500,000
Less: Amount of money received:		
Cash	$50,000	
Amount of liabilities subject to which property was transferred	150,000	
		200,000
Difference		$300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		$500,000

Example (2). (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of $100,000, a fair market value of $220,000, but is subject to a mortgage of $80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of $175,000, a fair market value of $250,000, but is subject to a mortgage of $150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefor $40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of $120,000 on the exchange, computed as follows:

Value of property received		$250,000
Cash		40,000
Liabilities subject to which old property was transferred		80,000
Total consideration received		$370,000
Less:		
Adjusted basis of property transferred	$100,000	
Liabilities to which new property is subject	150,000	
		250,000
Gain realized		$120,000

For purposes of section 1031(b), the amount of "other property or money" received by D is $40,000. (Consideration received by D in the form of a transfer subject to a liability of $80,000 is offset by consideration given in the form of a receipt of property subject to a $150,000 liability. Thus, only the consideration received in the form of cash, $40,000, is treated as "other property or money" for purposes of section 1031(b).) Accordingly, under section 1031(b), $40,000 of the $120,000 gain is recognized. The basis of the apartment house acquired by D is $170,000, computed as follows:

Adjusted basis of property transferred		$100,000
Liabilities to which new property is subject		150,000
Total		$250,000
Less: Amount of money received:		
Cash	$40,000	
Amount of liabilities subject to which property was transferred	80,000	
		120,000
Difference		$130,000
Plus: Amount of gain recognized upon the exchange		40,000
Basis of property acquired upon the exchange		$170,000

(c) E realizes a gain of $75,000 on the exchange, computed as follows:

Value of property received		$220,000
Liabilities subject to which old property was transferred		150,000
Total consideration received		$370,000
Less:		
Adjusted basis of property transferred	$175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
		295,000
Gain realized		$75,000

For purposes of section 1031(b), the amount of "other property or money" received by E is $30,000. (Consideration received by E in the form of a transfer subject to a liability of $150,000 is offset by consideration given in the form of a receipt of property subject to an $80,000 liability and by the $40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), $30,000 of the $75,000 gain is recognized. The basis of the apartment house acquired by E is $175,000, computed as follows:

Adjusted basis of property transferred		$175,000
Cash		40,000
Liabilities to which new property is subject		$80,000
Total		$295,000
Less: Amount of money received:		
Amount of liabilities subject to which property was transferred	$150,000	
		150,000
Difference		$145,000
Plus: Amount of gain recognized upon the exchange		30,000
Basis of property acquired upon the exchange		$175,000

§ 1.1032 STATUTORY PROVISIONS; EXCHANGE OF STOCK FOR PROPERTY.

SEC. 1032. EXCHANGE OF STOCK FOR PROPERTY.

(a) NONRECOGNITION OF GAIN OR LOSS.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

(b) BASIS.—For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

§ 1.1032–1 DISPOSITION BY A CORPORATION OF ITS OWN CAPITAL STOCK.—(a) The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. For example, the receipt by a corporation of the subscription price of shares of its stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be equal to, in excess of, or less than, the par or stated value of such stock. Also, the exchange or sale by a corporation of its own shares for money or other property does not result in taxable gain or deductible loss, even though the corporation deals in such shares as it might in the shares of another corporation. A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.

(b) Section 1032(a) does not apply to the acquisition by a corporation of shares of its own stock except where the corporation acquires

such shares in exchange for shares of its own stock (including treasury stock). See § 1.311–1(e) relating to treatment of acquisitions of a corporation's own stock. Section 1032(a) also does not relate to the tax treatment of the recipient of a corporation's stock.

(c) Where a corporation acquires shares of its own stock in exchange for shares of its own stock (including treasury stock) the transaction may qualify not only under section 1032(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights).

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§ 1.1034 Statutory Provisions; Common Nontaxable Exchanges; Sale or Exchange of Residence.

SEC. 1034. SALE OR EXCHANGE OF RESIDENCE.

(a) Nonrecognition of Gain.—If property (in this section called "old residence") used by the taxpayer as his principal residence is sold by him after December 31, 1953, and, within a period beginning 1 year before the date of such sale and ending 1 year after such date, property (in this section called "new residence") is purchased and used by the taxpayer as his principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price (as defined in subsection (b)) of the old residence exceeds the taxpayer's cost of purchasing the new residence.

(b) Adjusted Sales Price Defined.—

(1) In general.—For purposes of this section, the term "adjusted sales price" means the amount realized, reduced by the aggregate of the expenses for work performed on the old residence in order to assist in its sale.

(2) Limitations.—The reduction provided in paragraph (1) applies only to expenses—

(A) for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into;

(B) which are paid on or before the 30th day after the date of the sale of the old residence; and

(C) which are—

(i) not allowable as deductions in computing taxable income under section 63 (a) (defining taxable income), and

(ii) not taken into account in computing the amount realized from the sale of the old residence.

(3) Effective date.—The reduction provided in paragraph (1) applies to expenses for work performed in any taxable year (whether beginning before, on, or after January 1, 1954), but only in the case of a sale or exchange of an old residence which occurs after December 31, 1953.

(c) Rules for Application of Section.—For purposes of this section:

(1) An exchange by the taxpayer of his residence for other property shall be treated as a sale of such residence, and the acquisition of a residence on the exchange of property shall be treated as a purchase of such residence.

(2) A residence any part of which was constructed or reconstructed by the taxpayer shall be treated as purchased by the taxpayer. In determining the taxpayer's cost of purchasing a residence, there shall be included only so much of his cost as is attributable to the acquisition, construction, reconstruction, and improvements made which are properly

chargeable to capital account, during the period specified in subsection (a).

(3) If a residence is purchased by the taxpayer before the date of his sale of the old residence, the purchased residence shall not be treated as his new residence if sold or otherwise disposed of by him before the date of the sale of the old residence.

(4) If the taxpayer, during the period described in subsection (a), purchases more than one residence which is used by him as his principal residence at some time within 1 year after the date of the sale of the old residence, only the last of such residences so used by him after the date of such sale shall constitute the new residence.

(5) In the case of a new residence the construction of which was commenced by the taxpayer before the expiration of one year after the date of the sale of the old residence, the period specified in subsection (a), and the 1 year referred to in paragraph (4) of this subsection, shall be treated as including a period of 18 months beginning with the date of the sale of the old residence.

(d) LIMITATION.—Subsection (a) shall not apply with respect to the sale of the taxpayer's residence if within 1 year before the date of such sale the taxpayer sold at a gain other property used by him as his principal residence, and any part of such gain was not recognized by reason of subsection (a) or section 112(n) of the Internal Revenue Code of 1939.

(e) BASIS OF NEW RESIDENCE.—Where the purchase of a new residence results, under subsection (a) or under section 112(n) of the Internal Revenue Code of 1939, in the nonrecognition of gain on the sale of an old residence, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain not so recognized on the sale of the old residence. For this purpose, the amount of the gain not so recognized on the sale of the old residence includes only so much of such gain as is not recognized by reason of the cost, up to such time, of purchasing the new residence.

(f) TENANT-STOCKHOLDER IN A COOPERATIVE HOUSING CORPORATION.—For purposes of this section, section 1016 (relating to adjustments to basis), and section 1223 (relating to holding period), references to property used by the taxpayer as his principal residence, and references to the residence of a taxpayer, shall include stock held by a tenant-stockholder (as defined in section 216, relating to deduction for amounts representing taxes and interest paid to a cooperative housing corporation) in a cooperative housing corporation (as defined in such section) if—

(1) in the case of stock sold, the house or apartment which the taxpayer was entitled to occupy as such stockholder was used by him as his principal residence, and

(2) in the case of stock purchased the taxpayer used as his principal residence the house or apartment which he was entitled to occupy as such stockholder.

(g) HUSBAND AND WIFE.—If the taxpayer and his spouse, in accordance with regulations which shall be prescribed by the Secretary or his delegate pursuant to this subsection, consent to the application of paragraph (2) of this subsection, then—

(1) for purposes of this section—

(A) the taxpayer's adjusted sales price of the old residence is the adjusted sales price (of the taxpayer, or of the taxpayer and his spouse) of the old residence, and

(B) the taxpayer's cost of purchasing the new residence is the cost (to the taxpayer, his spouse, or both) of purchasing the new residence (whether held by the taxpayer, his spouse, or the taxpayer and his spouse); and

(2) so much of the gain on the sale of the old residence as is not recognized solely by reason of this subsection, and so much of the adjustment under subsection (e) to the basis of the new residence as results solely from this subsection shall be allocated between the taxpayer and his spouse as provided in such regulations.

This subsection shall apply only if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence.

§ 1.1034

In case the taxpayer and his spouse do not consent to the application of paragraph (2) of this subsection then the recognition of gain on the sale of the old residence shall be determined under this section without regard to the rules provided in this subsection.

(h) MEMBERS OF ARMED FORCES.—The running of any period of time specified in subsection (a) or (c) (other than the 1 year referred to in subsection (c)(4)) shall be suspended during any time that the taxpayer (or his spouse if the old residence and the new residence are each used by the taxpayer and his spouse as their principal residence) serves on extended active duty with the Armed Forces of the United States after the date of the sale of the old residence and during an induction period (as defined in section 112(c) (5)) except that any such period of time as so suspended shall not extend beyond the date 4 years after the date of the sale of the old residence. For purposes of this subsection, the term "extended active duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

(i) SPECIAL RULE FOR INVOLUNTARY CONVERSIONS.—

(1) IN GENERAL.—For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof—

(A) if occurring after December 31, 1950, and before January 1, 1954, shall be treated as the sale of such property; and

(B) if occurring after December 31, 1953, shall not be treated as the sale of such property.

(2) CROSS REFERENCE.—For treatment of residences involuntarily converted after December 31, 1953, see section 1033 (relating to involuntary conversions).

(j) STATUTE OF LIMITATIONS.—If after December 31, 1950, the taxpayer during a taxable year sells at a gain property used by him as his principal residence, then—

(1) the statutory period for the assessment of any deficiency attributable to any part of such gain shall not expire before the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of—

(A) the taxpayer's cost of purchasing the new residence which the taxpayer claims results in nonrecognition of any part of such gain,

(B) the taxpayer's intention not to purchase a new residence within the period specified in subsection (a). or

(C) a failure to make such purchase within such period; and

(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

§ 1.1034-1 SALE OR EXCHANGE OF RESIDENCE.—(a) *Nonrecognition of gain; general statement.*—Section 1034 provides rules for the nonrecognition of gain in certain cases where a taxpayer sells one residence after December 31, 1953, and buys or builds, and uses as his principal residence, another residence within specified time limits before or after such sale. In general, if the taxpayer invests in a new residence an amount at least as large as the adjusted sales price of his old residence, no gain is recognized on the sale of the old residence (see paragraph (b) of this section for definition of "adjusted sales price," "new residence," and "old residence"). On the other hand, if the new residence costs the taxpayer less than the adjusted sales price of the old residence, gain is recognized to the extent of the difference. Thus, if an amount equal to or greater than the adjusted sales price of an old residence is invested in a new residence, according to the rules stated in section 1034, none of the gain (if any) realized from the sale shall be recognized. If an amount less than such adjusted

sales price is so invested, gain shall be recognized, but only to the extent provided in section 1034. If there is no investment in a new residence, section 1034 is inapplicable and all of the gain shall be recognized. Whenever, as a result of the application of section 1034, any or all of the gain realized on the sale of an old residence is not recognized, a corresponding reduction must be made in the basis of the new residence. The provisions of section 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable. Section 1034 applies only to gains; losses are recognized or not recognized without regard to the provisions of this section. Section 1034 affects only the amount of gain recognized, and not the amount of gain realized (see also section 1001 and regulations issued thereunder). Any gain realized upon disposition of other property in exchange for the new residence is not affected by section 1034.

(b) *Definitions.*—The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):

(1) "Old residence" means property used by the taxpayer as his principal residence which is the subject of a sale by him after December 31, 1953 (section 1034(a); for detailed explanation see paragraph (c)(3) of this section).

(2) "New residence" means property used by the taxpayer as his principal residence which is the subject of a purchase by him (section 1034(a); for detailed explanation and limitations see paragraph (c)(3) and (d)(1) of this section).

(3) "Adjusted sales price" means the amount realized reduced by the fixing-up expenses (section 1034(b)(1); for special rule applicable in some cases to husband and wife see paragraph (f) of this section).

(4) "Amount realized" is to be computed by subtracting

(i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the considerations received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from

(ii) The amount of the consideration so received, determined (in accordance with section 1001(b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the "amount realized."

(5) "Gain realized" is the excess (if any) of the amount realized over the adjusted basis of the old residence (see also section 1001(a) and regulations issued thereunder).

(6) "Fixing-up expenses" means the aggregate of the expenses for work performed (in any taxable year, whether beginning before, on, or after January 1, 1954) on the old residence in order to assist in its sale, provided that such expenses (i) are incurred for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into; and (ii) are paid on or before the 30th day after the date of the sale of the old residence; and (iii) are neither (*a*) allowable as deductions in computing taxable income under section 63(a), nor (*b*) taken into account in computing the amount realized from the sale of the old residence (section 1034(b)(2) and (3)). "Fixing-up expenses" does not include expenditures which are properly chargeable to capital account and which would, therefore, constitute adjustments to the basis of the old residence (see section 1016 and regulations issued thereunder).

(7) "Cost of purchasing the new residence" means the total of all amounts which are attributable to the acquisition, construction, reconstruction, and improvements constituting capital expenditures, made during the period beginning one year before the date of sale of the old residence and ending either (i) one year after such date in the case of a new residence purchased but not constructed by the taxpayer, or (ii) 18 months after such date in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of one year after such date (section 1034(a), (c)(2) and (c)(5); for detailed explanation see paragraph (c)(4) of this section; for special rule applicable in some cases to husband and wife see paragraph (f) of this section; see also paragraph (b)(9) of this section for definition of "purchase").

(8) "Sale" (of a residence) means a sale or an exchange (of a residence) for other property either of which occurs after December 31, 1953, or an involuntary conversion (of a residence) which occurs after December 31, 1950, and before January 1, 1954 (section 1034(c)(1) and (i)(1)(A)); for detailed explanation concerning involuntary conversion see paragraph (h) of this section.

(9) "Purchase" (of a residence) means a purchase or an acquisition (of a residence) on the exchange of property or the partial or total construction or reconstruction (of a residence) by the taxpayer (section 1034(c)(1) and (2)). However, the mere improvement of a residence, not amounting to reconstruction, does not constitute "purchase" of a residence.

(c) *Rules for application of section 1034.*—(1) *General rule; limitations on applicability.*—Gain realized from the sale (after December 31, 1953) of an old residence will be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence, provided that the taxpayer either (i) within a period beginning one year before the date of such sale and ending one year after such date purchases prop-

erty and uses it as his principal residence, or (ii) within a period beginning one year before the date of such sale and ending 18 months after such date uses as his principal residence a new residence the construction of which was commenced by him at any time before the expiration of one year after the date of the sale of the old residence (section 1034(a) and (c)(5); for detailed explanation of use as "principal residence" see subparagraph (3) of this paragraph). The rule stated in the preceding sentence applies to a new residence purchased by the taxpayer before the date of sale of the old residence provided the new residence is still owned by him on such date (section 1034(c)(3)). Whether the construction of a new residence was commenced by the taxpayer before the expiration of one year after the date of the sale of the old residence will depend upon the facts and circumstances of each case. Section 1034 is not applicable to the sale of a residence if within the previous year the taxpayer made another sale of residential property on which gain was realized but not recognized (section 1034(d)). For further details concerning limitations on the application of section 1034, see paragraph (d) of this section.

(2) *Computation and examples.*—In applying the general rule stated in subparagraph (1) of this paragraph, the taxpayer should first subtract the commissions and other selling expenses from the selling price of his old residence, to determine the amount realized. A comparison of the amount realized with the cost or other basis of the old residence will then indicate whether there is any gain realized on the sale. Unless the amount realized is greater than the cost or other basis, no gain is realized and section 1034 does not apply. If the amount realized exceeds the cost or other basis, the amount of such excess constitutes the gain realized. The amount realized should then be reduced by the fixing-up expenses (if any), to determine the adjusted sales price. A comparison of the adjusted sales price of the old residence with the cost of purchasing the new residence will indicate how much (if any) of the realized gain is to be recognized. If the cost of purchasing the new residence is the same as, or greater than, the adjusted sales price of the old residence, then none of the realized gain is to be recognized. On the other hand, if the cost of purchasing the new residence is smaller than the adjusted sales price of the old residence, the gain realized is to be recognized to the extent of the difference. (It should be noted that any amount of gain realized but not recognized is to be applied as a downward adjustment to the basis of the new residence (for details see paragraph (e) of this section).) The application of the general rule stated above may be illustrated by the following examples:

Example (1). A taxpayer decides to sell his residence, which has a basis of $17,500. To make it more attractive to buyers, he paints the outside at a cost of $300 in April 1954. He pays for the painting when the work is finished. In May, 1954, he sells the house for $20,000. Brokers' commissions and other selling expenses are $1,000. In October, 1954, the taxpayer buys a new residence for $18,000. The amount realized, the gain realized, the adjusted sales price, and the gain to be recognized are computed as follows:

Selling price	$20,000	
Less: Commissions and other selling expenses	1,000	
Amount realized	$19,000	
Less: Basis	17,500	
Gain realized		$1,500
Amount realized	$19,000	
Less: Fixing-up expenses	300	
Adjusted sales price	$18,700	
Cost of purchasing new residence	18,000	
Gain recognized		$700
Gain realized but not recognized		$800
Adjusted basis of new residence (see paragraph (e) of this section)	$17,200	

Example (2). The facts are the same as in example (1), except that the selling price of the old residence is $18,500. The computations are as follows:

Selling price	$18,500	
Less: Commissions and other selling expenses	1,000	
Amount realized	$17,500	
Less: Basis	17,500	
Gain realized		$0

(NOTE: Since no gain is realized, section 1034 is inapplicable; it is, therefore, unnecessary to compute the adjusted sales price of the old residence and compare it with the cost of purchasing the new residence. No adjustment to the basis of the new residence is to be made.)

Example (3). The facts are the same as in example (1), except that the cost of purchasing the new residence is $17,000. The computations are as follows:

Selling price	$20,000	
Less: Commissions and other selling expenses	1,000	
Amount realized	$19,000	
Less: Basis	17,500	
Gain realized		$1,500
Amount realized	$19,000	
Less: Fixing-up expenses	300	
Adjusted sales price	$18,700	
Cost of purchasing the new residence	17,000	
Gain recognized		$1,500

(NOTE: Since the adjusted sales price of the old residence exceeds the cost of purchasing the new residence by $1,700, which is more than the gain realized, all of the gain realized is recognized. No adjustment to the basis of the new residence is to be made.)

Gain realized but not recognized	$0

Example (4). The facts are the same as in example (1), except

that the fixing-up expenses are $1,100. The computations are as follows:

Selling price	$20,000	
Less: Commissions and other selling expenses	1,000	
Amount realized	$19,000	
Less: Basis	17,500	
Gain realized		$1,500
Amount realized	$19,000	
Less: Fixing-up expenses	1,100	
Adjusted sales price	$17,900	
Cost of purchasing the new residence	18,000	
Gain recognized		$0
(NOTE: Since the cost of purchasing the new residence exceeds the adjusted sales price, none of the gain realized is recognized.)		
Gain realized but not recognized		$1,500
Adjusted basis of new residence (see paragraph (e) of this section)	$16,500	

(3) *Property used by the taxpayer as his principal residence.*—(i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034(f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes

only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(4) *Cost of purchasing new residence.*—(i) The taxpayer's cost of purchasing the new residence includes not only cash but also any indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determining such cost. In the case of an acquisition of a residence upon an exchange which is considered as a "purchase" under this section, the fair market value of the new residence on the date of the exchange shall be considered as the taxpayer's cost of purchasing the new residence. Where any part of the new residence is acquired by the taxpayer other than by "purchase," the value of such part is not to be included in determining the taxpayer's cost of the new residence (see paragraph (b) (9) of this section for definition of "purchase"). For example, if the taxpayer acquires a residence by gift or inheritance, and spends $20,000 in reconstructing such residence, only such $20,000 may be treated as his cost of purchasing the new residence.

(ii) The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the 2-year or 30-month period of time, as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Thus, if the construction of the new residence is begun two years before the date of sale of the old residence and completed on the date of sale of the old residence, only that portion of the cost which is attributable to the second year of such construction constitutes the taxpayer's cost of purchasing the new residence, for purposes of section 1034. Furthermore, the taxpayer's cost of purchasing the new residence includes only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see section 263.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. M began the construction of a new residence on January 15, 1955, and completed it on October 14, 1955. The cost of $18,000 was incurred ratably over the 9-month period of construction. On July 14, 1956, M sold his old residence and realized a gain of $7,200. In determining the extent to which the realized gain is not to be recognized under section 1034, M's cost of constructing the new residence shall include only the $6,000 which was attributable to the July 15–October 14, 1955, period (3 months at $2,000). The $12,000 balance of the cost of constructing the new residence was not attributable to the period beginning one year before the date of sale of the old residence and ending 18 months after such date and, under section 1034, is not properly a part of M's cost of constructing the new residence.

(d) *Limitations on application of section 1034.*—(1) If a residence is purchased by the taxpayer prior to the date of the sale of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence (section 1034(c)(3)). And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the one year (or 18 months in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence (section 1034(c)(4)). If within one year before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section or section 112(n) of the Internal Revenue Code of 1939, this section shall not apply with respect to the sale of the old residence (section 1034(d)).

(2) The following example will illustrate the rules of subparagraph (1) of this paragraph:

Example. A taxpayer sells his old residence on January 15, 1954, and purchases another residence on February 15, 1954. On March 15, 1954, he sells the residence which he bought on February 15, 1954, and purchases another residence on April 15, 1954. The gain on the sale of the old residence on January 15, 1954, will not be recognized except to the extent to which the taxpayer's adjusted sales price of the old residence exceeds the cost of purchasing the residence which he purchased on April 15, 1954. Gain on the sale of the residence which was bought on February 15, 1954, and sold on March 15, 1954, will be recognized.

(e) *Basis of new residence.*—(1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of the gain realized upon the sale of an old residence, then, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain which was not recognized upon the sale of the old residence (section 1034(e); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section). Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1) of this paragraph:

Example. On January 1, 1954, the taxpayer buys a new residence for $10,000. On March 1, 1954, he sells for an adjusted

sales price of $15,000 his old residence, which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $15,000 is the "amount realized" as well as the "adjusted sales price"). Between April 1 and April 15 a wing is constructed on the new house at a cost of $5,000. Between May 1 and May 15 a garage is constructed at a cost of $2,000. The adjusted basis of the new residence is $10,000 during January and February, $5,000 during March, $5,000 following the completion of the construction in April, and $7,000 following the completion of the construction in May. Since the old residence was not sold until March 1, no adjustment to the basis of the new residence is made during January and February. Computations for March, April, and May are as follows:

Amount realized on sale of old residence	$15,000	
Less: Adjusted basis of old residence	5,000	
Gain realized on sale of old residence		$10,000

March 1, 1954

Adjusted sales price of old residence	$15,000	
Less: Cost of purchasing new residence	10,000	
Gain recognized		$5,000
Gain realized but not recognized		$5,000
Cost of purchasing new residence	$10,000	
Less: Gain realized but not recognized	5,000	
Adjusted basis of new residence	$5,000	

April 15, 1954

Gain realized on sale of old residence		$10,000
Adjusted sales price of old residence	$15,000	
Less: Cost of purchasing new residence	15,000	
Gain recognized		$0
Gain realized but not recognized		$10,000
Cost of purchasing new residence	$15,000	
Less: Gain realized but not recognized	10,000	
Adjusted basis of new residence	$5,000	

May 15, 1954

Gain realized on sale of old residence		$10,000
Adjusted sales price of old residence	$15,000	
Less: Cost of purchasing new residence	17,000	
Gain recognized		$0
Gain realized but not recognized		$10,000
Cost of purchasing new residence	$17,000	
Less: Gain realized but not recognized	10,000	
Adjusted basis of new residence	$7,000	

(f) *Husband and wife.*—(1) If the taxpayer and his spouse file the consent referred to in this paragraph, then the "taxpayer's adjusted sales price of the old residence" shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the "taxpayer's cost of purchasing the new residence" shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (section 1034(g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(2) The consent referred to in subparagraph (1) of this paragraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided. Such consent shall be filed with the district director with whom the taxpayer filed the return for the taxable year or years in which the gain from the sale of the old residence was realized.

(3) The following examples will illustrate the application of this rule:

Example (1). A taxpayer, in 1954, sells for an adjusted sales price of $10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of $5,000 (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale he and his wife contribute $5,000 each from their separate funds for the purchase of their new principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of $5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be $2,500 and the adjusted basis of his wife's interest in such property will be $2,500.

Example (2). A taxpayer and his wife, in 1954, sell for an adjusted sales price of $10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of $2,500 to each of them ($5,000 together) (no fixing-up expenses are involved, so that $10,000 is the "amount realized" as well as the "adjusted sales price"). Within a year after such sale, the wife spends $10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her

name only. If the taxpayer and his wife file the required consent. the adjusted basis to the wife of the new residence will be $5,000, and the gain of the taxpayer of $2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of $2,500 on the sale of the old residence not recognized under the general rule.

(g) *Members of Armed Forces.*—(1) Section 1034(h) provides a special rule for members of the Armed Forces with respect to the period after the sale of the old residence within which the acquisition of a new residence may result in a nonrecognition of gain on such sale. The running of the 1-year period after the sale of the old residence in the case of the purchase of a new residence, or the 18-month period after such sale in the case of the construction of a new residence, is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces of the United States during an induction period (as defined in section 112(c)(5)). However, in no event may such suspension extend for more than four years after the date of the sale of the old residence the period within which the purchase or construction of a new residence may result in a nonrecognition of gain. For example, if the taxpayer is on extended active duty with the Army from January 1, 1951, to December 31, 1953, and if he sold his old residence on January 1, 1951, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of the old residence not recognized under this section is January 1, 1955, the date four years after the date of sale of the old residence.

(2) This suspension covers not only the Armed Forces service of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (c)(4) of this section.

(4) The running of the 1-year (or 18-month) period after the date of sale of the old residence referred to in section 1034(c)(4) and in paragraph (d) of this section is not suspended; neither is the running of the 1-year period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section.

(5) The term "extended active duty" means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days, if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see paragraph (i) of § 1.112–1. As to who are members of the Armed Forces of the United States, see section 7701(a)(15), and the regulations thereunder.

(h) *Special rule for involuntary conversions.*—Section 1034 is inapplicable to involuntary conversions of personal residences occurring after December 31, 1953 (section 1034(i)(1)(B)). However, for purposes of section 1034, an involuntary conversion of a personal residence occurring after December 31, 1950, and before January 1, 1954, is treated as a sale of such residence (section 1034(i)(1)(A); see paragraph (b)(8) of this section). For the purposes of this section an involuntary conversion is defined as the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. See section 1033 for treatment of residences involuntarily converted after December 31, 1953.

(i) *Statute of limitations.*—(1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 6501(a) for the assessment of a deficiency attributable to any part of such gain shall not expire prior to the expiration of three years from the date of receipt, by the district director with whom the return was filed for the taxable year or years in which the gain from the sale of the old residence was realized (section 1034(j)), of a written notice from the taxpayer of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims results in nonrecognition of any part of such gain,

(ii) The taxpayer's intention not to purchase a new residence within the period when such a purchase will result in nonrecognition of any part of such gain, or

(iii) The taxpayer's failure to make such a purchase within such period.

Any gain from the sale of the old residence which is required to be recognized shall be included in gross income for the taxable year or years in which such gain was realized. Any deficiency attributable to any portion of such gain may be assessed before the expiration of the 3-year period described in this paragraph, notwithstanding the provisions of any law or rule of law which might otherwise bar such assessment.

(2) The notification required by the preceding subparagraph shall contain all pertinent details in connection with the sale of the old residence and, where applicable, the purchase price of the new residence. The notification shall be in the form of a written statement and shall be accompanied, where appropriate, by an amended return for the year in which the gain from the sale of the old residence was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(j) *Effective date.*—Pursuant to section 7851(a)(1)(C), paragraphs (a), (b), (c), (d), (f), (g), and (i) of this section apply in the case of any "sale" (as defined in paragraph (b)(8) of this section) made after December 31, 1953, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939. Similarly, the rule in paragraph (h) of this section that involuntary conversions of personal residences are not to be treated as sales for purposes of section 1034 but are governed by section 1033 applies to any such in-

voluntary conversion made after December 31, 1953, although such involuntary conversion may occur in a taxable year subject to the Internal Revenue Code of 1939. The rule in paragraph (e) of this section requiring an adjustment to the basis of a new residence, the purchase of which results (under section 1034, or section 112(n) of the Internal Revenue Code of 1939) in the nonrecognition of gain on the sale of an old residence, applies in determining the adjusted basis of the new residence at any time following such sale, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939.

§ 1.1035. STATUTORY PROVISIONS; CERTAIN EXCHANGES OF INSURANCE POLICIES.

SEC. 1035. CERTAIN EXCHANGES OF INSURANCE POLICIES.

(a) GENERAL RULES.—No gain or loss shall be recognized on the exchange of—

(1) a contract of life insurance for another contract of life insurance or for an endowment or annuity contract; or

(2) a contract of endowment insurance (A) for another contract of endowment insurance which provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or (B) for an annuity contract; or

(3) an annuity contract for an annuity contract.

(b) DEFINITIONS.—For the purpose of this section—

(1) ENDOWMENT CONTRACT.—A contract of endowment insurance is a contract with a life insurance company as defined in section 801 which depends in part on the life expectancy of the insured, but which may be payable in full in a single payment during his life.

(2) ANNUITY CONTRACT.—An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments.

(3) LIFE INSURANCE CONTRACT.—A contract of life insurance is a contract to which paragraph (1) applies but which is not ordinarily payable in full during the life of the insured.

(c) CROSS REFERENCES.—

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

§ 1.1035–1 CERTAIN EXCHANGES OF INSURANCE POLICIES.—Under the provisions of section 1035 no gain or loss is recognized on the exchange of—

(a) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract (section 1035(a)(1));

(b) A contract of endowment insurance for another contract of endowment insurance providing for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or an annuity contract (section 1035(a)(2)); or

(c) An annuity contract for another annuity contract (section 1035(a)(3)),

but section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same

person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section 1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031(b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations thereunder.

§ 1.1036 Statutory Provisions; Stock for Stock of Same Corporation.

SEC. 1036. STOCK FOR STOCK OF SAME CORPORATION.

(a) General Rule.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(b) Cross References.—

(1) For rules relating to recognition of gain or loss where an exchange is not solely in kind, see subsections (b) and (c) of section 1031.

(2) For rules relating to the basis of property acquired in an exchange described in subsection (a), see subsection (d) of section 1031.

§ 1.1036–1 Stock for Stock of the Same Corporation.—(a) Section 1036 permits the exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation. Section 1036 applies even though voting stock is exchanged for nonvoting stock or nonvoting stock is exchanged for voting stock. It is not limited to an exchange between two individual stockholders; it includes a transaction between a stockholder and the corporation. However, a transaction between a stockholder and the corporation may qualify not only under section 1036(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights). The provisions of section 1036(a) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See § 1.301–1(l) for certain transactions treated as distributions under section 301. See § 1.368–2(e) for certain transactions treated as distributions under section 305(b)(1).

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a

liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b).

SPECIAL RULES

§ 1.1051 Statutory Provisions; Property Acquired During Affiliation.

SEC. 1051. PROPERTY ACQUIRED DURING AFFILIATION.

In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Secretary or his delegate, without regard to inter-company transactions in respect of which gain or loss was not recognized. For purposes of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made by such corporation under chapter 6 of this subtitle (sec. 1501 and following) or under section 141 of the Internal Revenue Code of 1939 or of the Revenue Act of 1938, 1936, 1934, 1932, or 1928 shall be determined in accordance with regulations prescribed under section 1502 or in accordance with regulations prescribed under the appropriate section 141, as the case may be. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made by such corporation under chapter 6 of this subtitle or such section 141 shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 1502 or in accordance with regulations prescribed under the appropriate section 141, as the case may be.

§ 1.1051–1 Basis of Property Acquired During Affiliation.—(a)(1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term "period of affiliation" means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for $120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for $130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of $100,000. The basis of the assets in the hands of the Z Corporation is $100,000.

(b) The basis of property acquired by a corporation during any

period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502, or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Acts of 1938, 1936, 1934, 1932, or 1928, the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§ 1.1052 STATUTORY PROVISIONS; BASIS ESTABLISHED BY THE REVENUE ACT OF 1932 OR 1934 OR BY THE INTERNAL REVENUE CODE OF 1939.

SEC. 1052. BASIS ESTABLISHED BY THE REVENUE ACT OF 1932 OR 1934 OR BY THE INTERNAL REVENUE CODE OF 1939.

(a) REVENUE ACT OF 1932.—If the property was acquired, after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis thereof, for purposes of the Revenue Act of 1932 was prescribed by section 113(a)(6), (7), or (9) of such Act (47 Stat. 199), then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

(b) REVENUE ACT OF 1934.—If the property was acquired, after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis thereof, for purposes of the Revenue Act of 1934, was prescribed by section 113(a)(6), (7), or (8) of such Act (48 Stat. 706), then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Revenue Act of 1934.

(c) INTERNAL REVENUE CODE OF 1939.—If the property was acquired, after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied, and the basis thereof, for purposes of the Internal Revenue Code of 1939, was prescribed by section 113(a)(6), (7), (8), (13), (15), (18), (19), or (23) of such code, then for purposes of this subtitle the basis shall be the same as the basis therein prescribed in the Internal Revenue Code of 1939.

§ 1.1052–1 BASIS OF PROPERTY ESTABLISHED BY REVENUE ACT OF 1932.—Section 1052(a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932, was prescribed by section 113(a)(6), (7), or (9) of that Act, then for purposes of subtitle A the basis shall be the same as the basis prescribed in the Revenue Act of 1932. For the rules applicable in determining the basis of stocks or securities under section 113(a)(9) of the Revenue Act of 1932 in case of certain distributions after December 31, 1923, and in any taxable year beginning before January 1, 1934, see 26CFR(1939) 39.113(a)(12)–1 (Regulations 118).

§ 1.1052–2 BASIS OF PROPERTY ESTABLISHED BY REVENUE ACT OF 1934.—Section 1052(b) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1936, and the basis of the property for the purposes of the Revenue Act of 1934 was prescribed by section 113(a)(6), (7), or (8) of that

Act, then for purposes of subtitle A the basis shall be the same as the basis prescribed in the Revenue Act of 1934. For example, if after December 31, 1920, and in any taxable year beginning before January 1, 1936, property was acquired by a corporation by the issuance of its stock or securities in connection with a transaction which is not described in section 112(b)(5) of the Internal Revenue Code of 1939 but which is described in section 112(b)(5) of the Revenue Act of 1934, the basis of the property so acquired shall be the same as it would be in the hands of the transferor, with proper adjustments to the date of the exchange.

§ 1.1052–3 Basis of Property Established by the Internal Revenue Code of 1939.—Section 1052(c) provides that if property was acquired after February 28, 1913, in a transaction to which the Internal Revenue Code of 1939 applied and the basis thereof was prescribed by section 113(a)(6), (7), (8), (13), (15), (18), (19) or (23) of such Code, then for purposes of subtitle A the basis shall be the same as the basis prescribed in the Internal Revenue Code of 1939. In such cases see section 113(a) of the Internal Revenue Code of 1939 and the regulations thereunder.

§ 1.1053 Statutory Provisions; Basis of Property Acquired Before March 1, 1913.

SEC. 1053. PROPERTY ACQUIRED BEFORE MARCH 1, 1913.

In the case of property acquired before March 1, 1913, if the basis otherwise determined under this part, adjusted (for the period before March 1, 1913) as provided in section 1016, is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

§ 1.1053–1 Property Acquired Before March 1, 1913.—(a) *Basis for determining gain.*—In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining gain is the cost or other basis, adjusted as provided in section 1016 and other applicable provisions of chapter 1, or its fair market value as of March 1, 1913, whichever is greater.

(b) *Basis for determining loss.*—In the case of property acquired before March 1, 1913, the basis as of March 1, 1913, for determining loss is the basis determined in accordance with part II of subchapter O, or other applicable provisions of chapter 1, without reference to the fair market value as of March 1, 1913.

(c) *Example.*—The application of paragraphs (a) and (b) of this section may be illustrated by the following example:

Example.—(i) On March 1, 1908, a taxpayer purchased for $100,000, property having a useful life of 50 years. Assuming that there were no capital improvements to the property, the depreciation sustained on the property before March 1, 1913, was $10,000 (5 years @ $2,000), so that the original cost adjusted, as of March 1, 1913, for depreciation sustained prior to that date is $90,000. On that date the property had a fair market value of $94,500 with a remaining life of 45 years.

(ii) For the purpose of determining gain from the sale or other disposition of the property on March 1, 1954, the basis of the

property is the fair market value of $94,500 as of March 1, 1913, adjusted for depreciation allowed or allowable after February 28, 1913, computed on $94,500. Thus, the substituted basis, $94,500, is reduced by the depreciation adjustment from March 1, 1913, to February 28, 1954, in the aggregate of $86,100 (41 years @ $2,100), leaving an adjusted basis for determining gain of $8,400 ($94,500 less $86,100).

(iii) For the purpose of determining loss from the sale or other disposition of such property on March 1, 1954, the basis of the property is its cost, adjusted for depreciation sustained before March 1, 1913, computed on cost, and the amount of depreciation allowed or allowable after February 28, 1913, computed on the fair market value of $94,500 as of March 1, 1913. In this example, the amount of depreciation sustained before March 1, 1913, is $10,000 and the amount of depreciation determined for the period after February 28, 1913, is $86,100. Therefore, the aggregate amount of depreciation for which the cost ($100,000) should be adjusted is $96,100 ($10,000 plus $86,100), and the adjusted basis for determining loss on March 1, 1954, is $3,900 ($100,000 less $96,100).

(d) *Fair market value.*—The determination of the fair market value of property on March 1, 1913, is generally a question of fact and shall be established by competent evidence. In determining the fair market value of stock or other securities, due regard shall be given to the fair market value of the corporate assets as of such date, and other pertinent factors. In the case of property traded in on public exchanges, actual sales on or near the basic date afford evidence of value. In general, the fair market value of a block or aggregate of a particular kind of property is not to be determined by a forced-sale price or by an estimate of what a whole block or aggregate would bring if placed upon the market at one and the same time. In such a case the value should be determined by ascertaining as the basis the fair market value of each unit of the property. All relevant facts and elements of value as of the basic date should be considered in each case.

§ 1.1054 Statutory Provisions; Cross References.

SEC. 1054. CROSS REFERENCES.

(1) For nonrecognition of gain in connection with the transfer of obsolete vessels to the Maritime Administration under section 510 of the Merchant Marine Act, 1936, see subsection (e) of that section, as amended August 4, 1939 (46 U. S. C. 1160).

(2) For recognition of gain or loss in connection with the construction of new vessels, see section 511 of such Act, as amended (46 U. S. C. 1161).

(3) For nonrecognition of gain in connection with vessels exchanged with the Maritime Administration under section 8 of the Merchant Ship Sales Act of 1946, see subsection (a) of that section (50 U. S. C. App. 1741).

CHANGES TO EFFECTUATE F. C. C. POLICY

§ 1.1071 Statutory Provisions; Gain From Sale or Exchange To Effectuate Policies of Federal Communications Commission.

SEC. 1071. GAIN FROM SALE OR EXCHANGE TO EFFECTUATE POLICIES OF F. C. C.

(a) Nonrecognition of Gain or Loss.—If the sale or exchange of property (including stock in a corporation) is certified by the Federal Communi-

cations Commission to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations, such sale or exchange shall, if the taxpayer so elects, be treated as an involuntary conversion of such property within the meaning of section 1033. For purposes of such section as made applicable by the provisions of this section, stock of a corporation operating a radio broadcasting station, whether or not representing control of such corporation, shall be treated as property similar or related in service or use to the property so converted. The part of the gain, if any, on such sale or exchange to which section 1033 is not applied shall nevertheless not be recognized, if the taxpayer so elects, to the extent that it is applied to reduce the basis for determining gain or loss on sale or exchange of property, of a character subject to the allowance for depreciation under section 167, remaining in the hands of the taxpayer immediately after the sale or exchange, or acquired in the same taxable year. The manner and amount of such reduction shall be determined under regulations prescribed by the Secretary or his delegate. Any election made by the taxpayer under this section shall be made by a statement to that effect in his return for the taxable year in which the sale or exchange takes place, and such election shall be binding for the taxable year and all subsequent taxable years.

(b) BASIS.—For basis of property acquired on a sale or exchange treated as an involuntary conversion under subsection (a), see section 1033(c).

§ 1.1071–1 GAIN FROM SALE OR EXCHANGE TO EFFECTUATE POLICIES OF FEDERAL COMMUNICATIONS COMMISSION.—(a) At the election of the taxpayer, section 1071 in effect postpones the recognition of gain upon the sale or exchange of property, if the Federal Communications Commission certifies such sale or exchange to be necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations. Any taxpayer desiring to obtain the benefits of section 1071 shall file with the Commissioner of Internal Revenue, or the district director of internal revenue for the district in which the income tax return of the taxpayer is required to be filed, a certificate from the Federal Communications Commission clearly identifying the property and showing that the sale or exchange of such property is necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations. Such certificate shall be accompanied by a detailed statement showing: The kind of property, the date of acquisition, the cost or other basis of the property, the date of sale or exchange, the name and address of of the transferee, and the amount of money and the fair market value of the property other than money received upon such sale or exchange.

(b) Section 1071 applies only in the case of a sale or exchange made necessary by reason of the Federal Communications Commission's policies as to ownership or control of radio facilities. Section 1071 does not apply in the case of a sale or exchange made necessary as a result of other matters, such as the operation of a broadcasting station in a manner determined by the Commission to be not in the public interest or in violation of Federal or State law.

(c) An election to have the benefits of section 1071 shall be made in the manner prescribed in § 1.1071–4.

(d) For purposes of section 1071, the term "radio broadcasting" includes telecasting.

§ 1.1071–2 NATURE AND EFFECT OF ELECTION.—(a) *Alternative elections.*—(1) A taxpayer entitled to the benefits of section 1071 in respect of a sale or exchange of property may elect—

(i) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033; or

(ii) To treat such sale or exchange as an involuntary conversion under the provisions of section 1033, and in addition elect to reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain that would otherwise be recognized under section 1033; or

(iii) To reduce the basis of property, in accordance with the regulations prescribed in § 1.1071–3, by all or part of the gain realized upon the sale or exchange.

(2) The effect of the provisions of subparagraph (1) of this paragraph is, in general, to grant the taxpayer an election to treat the proceeds of the sale or exchange as the proceeds of an involuntary conversion subject to the provisions of section 1033, and a further election to reduce the basis of certain property owned by the taxpayer by the amount of the gain realized upon the sale or exchange to the extent of that portion of the proceeds which is not treated as the proceeds of an involuntary conversion.

(3) An election in respect to a sale or exchange under section 1071 shall be irrevocable and binding for the taxable year in which the sale or exchange takes place and for all subsequent taxable years.

(b) *Application of section 1033.*—(1) If the taxpayer elects, under either paragraph (a)(1)(i) or (ii) of this section, to treat the sale or exchange as an involuntary conversion, the provisions of section 1033, as modified by section 1071, together with the regulations prescribed under such sections, shall be applicable in determining the amount of recognized gain and the basis of property acquired as a result of such sale or exchange. For the purposes of section 1071 and the regulations thereunder, stock of a corporation operating a radio broadcasting station shall be treated as property similar or related in service or use to the property sold or exchanged. Securities of such a corporation other than stock, or securities of a corporation not operating a radio broadcasting station, do not constitute property similar or related in service or use to the property sold or exchanged. If the taxpayer exercises the election referred to in paragraph (a)(1)(i) of this section, the gain realized upon such sale or exchange shall be recognized to the extent of that part of the money received upon the sale or exchange which is not expended in the manner prescribed in section 1033 and the regulations thereunder. If, however, the taxpayer exercises the elections referred to in paragraph (a)(1)(ii) of this section, the amount of the gain which would be recognized, determined in the same manner as in the case of an election under paragraph (a)(1)(i) of this section, shall not be recognized but shall be applied to reduce the basis of property, remaining in the hands of the taxpayer after such sale or exchange or acquired by him during the same taxable year, which is of a character subject to the allowance for depreciation under section 167. Such reduction

of basis shall be made in accordance with and under the conditions prescribed by § 1.1071–3.

(2) In the application of section 1033 to determine the recognized gain and the basis of property acquired as a result of a sale or exchange pursuant to an election under paragraph (a)(1)(i) or (ii) of this section, the entire amount of the proceeds of such sale or exchange shall be taken into account.

(c) *Example.*—The application of the provisions of section 1071 may be illustrated by the following example:

Example. A, who makes his return on a calendar year basis, sold in 1954, for $100,000 cash, stock of X Corporation, which operates a radio broadcasting station. A's basis of this stock was $75,000. The sale was certified by the Federal Communications Commission as provided in section 1071. Soon after, in the same taxable year, A used $50,000 of the proceeds of the sale to purchase stock in Y Corporation, which operates a radio broadcasting station. A elected in his 1954 return to treat such sale and purchase as an involuntary conversion subject to the provisions of section 1033. He also elected at the same time to reduce the basis of depreciable property by the amount of the gain that otherwise would be recognized under the provisions of section 1033, as made applicable by section 1071. The sale results in a recognized gain of $25,000 under section 1033. However, this gain is not recognized in this case because the taxpayer elected to reduce the basis of other property by the amount of the gain. This may be shown as follows:

(1) Sale price of X Corporation stock	$100,000
Basis for gain or loss	75,000
Gain realized	$25,000
Proceeds of sale	$100,000
Amount expended to replace property sold	50,000
Amount not expended in manner prescribed in section 1033	$50,000
Realized gain, recognized under section 1033 (not to exceed the unexpended portion of proceeds of sale)	$25,000
Less: Amount applied as a reduction of basis of depreciable property	25,000
Recognized gain for tax purposes	None

(2) The basis of Y Corporation stock in the hands of A is $50,000, computed in accordance with section 1033 and the regulations prescribed under that section. The $50,000 basis is computed as follows:

Basis of property sold (converted)	$75,000
Less: Amount of proceeds not expended	50,000
Balance	$25,000
Plus amount of gain recognized under section 1033	25,000
Basis of Y Corporation stock in A's hands	$50,000

§ 1.1071–3 Reduction of Basis of Property Pursuant to Election Under Section 1071.—(a) *General rule.*—(1) In addition to the adjustments provided in section 1016 and other applicable pro-

visions of chapter 1, which adjustments are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in the amount of the unrecognized gain under section 1071, if the taxpayer so elects. Such further adjustment shall be made only with respect to the cost or other basis of property which is of a character subject to the allowance for depreciation under section 167 (whether or not used in connection with a broadcasting business), and which remains in the hands of the taxpayer immediately after the sale or exchange in respect of which the election is made, or which is acquired by the taxpayer in the same taxable year in which such sale or exchange occurs. If the property is in the hands of the taxpayer immediately after the sale or exchange, the time of reduction of the basis is the date of the sale or exchange; in all other cases the time of reduction of the basis is the date of acquisition.

(2) The reduction of basis under section 1071 in the amount of the unrecognized gain shall be made in respect of the cost or other basis, as of the time prescribed, of all units of property of the specified character. The cost or other basis of each unit shall be decreased in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) of such unit bears to the aggregate of such adjusted basis of all units of such property, but the amount of the decrease shall not be more than the amount of such adjusted basis. If in the application of such rule the adjusted basis of any unit is reduced to zero, the process shall be repeated to reduce the adjusted basis of the remaining units of property by the portion of the unrecognized gain which is not absorbed in the first application of the rule. For such purpose the "adjusted basis" of the remaining units shall be the adjusted basis for determining gain reduced by the amount of the adjustment previously made under this section. The process shall be repeated until the entire amount of the unrecognized gain has been absorbed.

(3) The application of the provisions of this section may be illustrated by the following example:

Example. Using the facts given in the example set forth in § 1.1071–2(c), except that the taxpayer elects to reduce the basis of depreciable property in accordance with paragraph (a)(1)(iii) of § 1.1071–2, the computation may be illustrated as follows:

Sale price of X Corporation stock		$100,000
Basis for gain or loss		75,000
Realized gain (recognized except for the election under § 1.1071–1)		$25,000
Adjusted basis of other depreciable property in hands of A immediately after sale:		
Building	$80,000	
Transmitter	16,000	
Fixtures	4,000	
Total	$100,000	

Computation of reduction:

Building	$\frac{80{,}000}{100{,}000} \times \$25{,}000$ (gain)	\$20,000
Transmitter	$\frac{16{,}000}{100{,}000} \times \$25{,}000$	4,000
Fixtures	$\frac{4{,}000}{100{,}000} \times \$25{,}000$	1,000
Total reduction		\$25,000

New basis of assets:

Building (\$80,000 minus \$20,000)	\$60,000
Transmitter (\$16,000 minus \$4,000)	12,000
Fixtures (\$4,000 minus \$1,000)	3,000
Total adjusted basis after reduction under section 1071	\$75,000
Realized gain upon sale of X Corporation stock	\$25,000
Less: Amount applied as a reduction to basis of depreciable property	25,000
Recognized gain for tax purposes	None

(b) *Special cases.*—With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property of the class specified in section 1071 and this section adjusted in a manner different from the general rule set forth in paragraph (a) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of such property. The request for variations from such general rule should be filed by the taxpayer with his return for the taxable year in which he elects to have the basis of property reduced under section 1071. Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121.

§ 1.1071–4 Manner of Election.—(a) An election under the provisions of section 1071 shall be in the form of a written statement and shall be executed and filed in duplicate. Such statement shall be signed by the taxpayer or his authorized representative. In the case of a corporation the statement shall be signed with the corporate name, followed by the signature and title of an officer of the corporation empowered to sign for the corporation, and the corporate seal must be affixed. An election under section 1071 to reduce the basis of property and an election under such section to treat the sale or exchange as an involuntary conversion under section 1033 may be exercised independently of each other. An election under section 1071 must be filed with the return for the taxable year in which the sale or exchange occurs. Where practicable, the certificate of the Federal Communications Commission required by § 1.1071–1 should be filed with the election.

(b) If, in pursuance of an election to have the basis of its property adjusted under section 1071, the taxpayer desires to have such basis adjusted in any manner different from the general rule set forth in paragraph (a) of § 1.1071–3, the precise method (including allocation of amounts) should be set forth in detail on separate sheets accom-

panying the election. Consent by the Commissioner to any departure from such general rule shall be effected only by a closing agreement entered into under the provisions of section 7121.

EXCHANGES IN OBEDIENCE TO S. E. C. ORDERS

§ 1.1081 Statutory Provisions; Exchanges and Distributions in Obedience to Orders of the Securities and Exchange Commission; Nonrecognition of Gain or Loss.

SEC. 1081. NONRECOGNITION OF GAIN OR LOSS ON EXCHANGES OR DISTRIBUTIONS IN OBEDIENCE TO ORDERS OF S. E. C.

(a) Exchanges of Stock or Securities Only.—No gain or loss shall be recognized to the transferor if stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are transferred to such corporation or to an associate company thereof which is a registered holding company or a majority-owned subsidiary company solely in exchange for stock or securities (other than stock or securities which are nonexempt property), and the exchange is made by the transferee corporation in obedience to an order of the Securities and Exchange Commission.

(b) Exchanges and Sales of Property by Corporations.—

(1) General rule.—No gain shall be recognized to a transferor corporation which is a registered holding company or an associate company of a registered holding company, if such corporation, in obedience to an order of the Securities and Exchange Commission, transfers property in exchange for property, and such order recites that such exchange by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member. Any gain, to the extent that it cannot be applied in reduction of basis under section 1082(a)(2), shall be recognized.

(2) Nonexempt property.—If any such property so received is nonexempt property, gain shall be recognized unless such nonexempt property or an amount equal to the fair market value of such property at the time of the transfer is, within 24 months of the transfer, under regulations prescribed by the Secretary or his delegate, and in accordance with an order of the Securities and Exchange Commission, expended for property other than nonexempt property or is invested as a contribution to the capital, or as paid-in surplus, of another corporation, and such order recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member. If the fair market value of such nonexempt property at the time of the transfer exceeds the amount expended and the amount invested, as required in the preceding sentence, the gain, if any, to the extent of such excess, shall be recognized.

(3) Cancellation or redemption of stock or securities.—For purposes of this subsection, a distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer) and a payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer shall be considered an expenditure for property other than nonexempt property, and if, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability shall be considered to be an expenditure by the transferor for property other than nonexempt property.

(4) Consents.—This subsection shall not apply unless the transferor corporation consents, at such time and in such manner as the Secretary or his delegate may by regulations prescribe to the regulations pre-

scribed under section 1082(a)(2) in effect at the time of filing its return for the taxable year in which the transfer occurs.

(c) DISTRIBUTION OF STOCK OR SECURITIES ONLY.—

(1) IN GENERAL.—If there is distributed, in obedience to an order of the Securities and Exchange Commission, to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), without the surrender by such shareholder of stock or securities in such corporation, no gain to the distributee from the receipt of the stock or securities so distributed shall be recognized.

(2) SPECIAL RULE.—If—

(A) there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation without the surrender by such shareholder of stock in the first corporation,

(B) such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (49 Stat. 810; 15 U. S. C. 79c) that such corporation is exempt from any provision or provisions of such Act, and

(C) before January 1, 1958, the first corporation disposes of all of the common stock in the second corporation which it owns,

then no gain to the distributee from the receipt of the right so distributed shall be recognized. If the first corporation does not, before January 1, 1958, dispose of all of the common stock which it owns in the second corporation, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment or the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting solely from the receipt of such rights to acquire stock, include one year immediately following the date on which the first corporation notifies the Secretary or his delegate whether or not the requirements of subparagraph (C) of the preceding sentence have been met; and such assessment and collection may be made notwithstanding any provision of law or rule of law which would otherwise prevent such assessment and collection.

(d) TRANSFERS WITHIN SYSTEM GROUP.—

(1) GENERAL RULE.—No gain or loss shall be recognized to a corporation which is a member of a system group—

(A) if such corporation transfers property to another corporation which is a member of the same system group in exchange for other property, and the exchange by each corporation is made in obedience to an order of the Securities and Exchange Commission, or

(B) if there is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, property, without the surrender by such shareholder of stock or securities in the corporation making the distribution, and the distribution is made and received in obedience to an order of the Securities and Exchange Commission.

If an exchange by or a distribution to a corporation with respect to which no gain or loss is recognized under any of the provisions of this paragraph may also be considered to be within the provisions of subsection (a), (b), or (c), then the provisions of this paragraph only shall apply.

(2) SALES OF STOCK OR SECURITIES.—If the property received on an exchange which is within any of the provisions of paragraph (1) consists in whole or in part of stock or securities issued by the corporation from which such property was received, and if in obedience to an order of the Securities and Exchange Commission such stock or securities (other than stock which is not preferred as to both dividends and assets) are sold and the proceeds derived therefrom are applied in whole or in part in the retirement or cancellation of stock or of securities of the recipient corporation outstanding at the time of such exchange, no gain or loss shall be recognized to the recipient corporation on the sale of the stock or securities with respect to which such order was made; except that if any part of the proceeds derived from the sale of such stock or securi-

ties is not so applied, or if the amount of such proceeds is in excess of the fair market value of such stock or securities at the time of such exchange, the gain, if any, shall be recognized, but in an amount not in excess of the proceeds which are not so applied, or in an amount not more than the amount by which the proceeds derived from such sale exceed such fair market value, whichever is the greater.

(e) EXCHANGES NOT SOLELY IN KIND.—

(1) GENERAL RULE.—If an exchange (not within any of the provisions of subsection (d)) would be within the provisions of subsection (a) if it were not for the fact that property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain or loss, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property, and the loss, if any, to the recipient shall not be recognized.

(2) DISTRIBUTION TREATED AS DIVIDEND.—If an exchange is within the provisions of paragraph (1) and if it includes a distribution which has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under such paragraph as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

(f) CONDITIONS FOR APPLICATION OF SECTION.—Except in the case of a distribution described in subsection (c)(2), the provisions of this section shall not apply to an exchange, expenditure, investment, distribution, or sale unless—

(1) the order of the Securities and Exchange Commission in obedience to which such exchange, expenditure, investment, distribution, or sale was made recites that such exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11 (b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k(b)),

(2) such order specifies and itemizes the stock and securities and other property which are ordered to be acquired, transferred, received, or sold on such exchange, acquisition, expenditure, distribution, or sale, and, in the case of an investment, the investment to be made, and

(3) such exchange, acquisition, expenditure, investment, distribution, or sale was made in obedience to such order, and was completed within the time prescribed therefor.

(g) NONAPPLICATION OF OTHER PROVISIONS.—If a distribution described in subsection (c)(2), or an exchange or distribution made in obedience to an order of the Securities and Exchange Commission, is within any of the provisions of this part and may also be considered to be within any of the other provisions of this subchapter or subchapter C (sec. 301 and following, relating to corporate distributions and adjustments), then the provisions of this part only shall apply.

§ 1.1081–1 TERMS USED.—The following terms, when used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, shall have the meanings assigned to them in section 1083: "Order of the Securities and Exchange Commission"; "registered holding company"; "holding company system"; "associate company"; "majority-owned subsidiary company"; "system group"; "nonexempt property"; and "stock or securities." Any other term used in this section and §§ 1.1081–2 to 1.1083–1, inclusive, which is defined in the Internal Revenue Code of 1954, shall be given the respective definition contained in such Code.

§ 1.1081–2 PURPOSE AND SCOPE OF EXCEPTION.—(a) The general rule is that the entire amount of gain or loss from the sale or exchange of property is to be recognized (see section 1002) and that the entire amount received as a dividend is to be included in gross income. (See

sections 61 and 301.) Exceptions to the general rule are provided elsewhere in subchapters C and O of chapter 1, one of which is that made by section 1081 with respect to exchanges, sales, and distributions specifically described in section 1081. Section 1081 provides the extent to which gain or loss is not to be recognized on (1) the receipt of a distribution described in section 1081(c)(2), or (2) an exchange or sale, or the receipt of a distribution, made in obedience to an order of the Securities and Exchange Commission, which is issued to effectuate the provisions of section 11(b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k(b)). Section 331 provides that a distribution in liquidation of a corporation shall be treated as an exchange. Such distribution is to be treated as an exchange under the provisions of sections 1081 to 1083, inclusive. The order of the Securities and Exchange Commission must be one requiring or approving action which the Commission finds to be necessary or appropriate to effect a simplification or geographical integration of a particular public utility holding company system. For specific requirements with respect to an order of the Securities and Exchange Commission see section 1081(f).

(b) The requirements for nonrecognition of gain or loss as provided in section 1081 are precisely stated with respect to the following general types of transactions:

(1) The exchange that is provided for in section 1081(a), in which stock or securities in a registered holding company or a majority-owned subsidiary company are exchanged for stock or securities.

(2) The exchange that is provided for in section 1081(b), in which a registered holding company or an associate company of a registered holding company exchanges property for property.

(3) The distribution that is provided for in section 1081(c)(1), in which stock or securities are distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, or the distribution that is provided for in section 1081(c)(2), in which a corporation distributes to a shareholder, rights to acquire common stock in a second corporation.

(4) The transfer that is provided for in section 1081(d), in which a corporation which is a member of a system group transfers property to another member of the same system group.

Certain rules with respect to the receipt of nonexempt property on an exchange described in section 1081(a) are prescribed in section 1081(e).

(c) These exceptions to the general rule are to be strictly construed. Unless both the purpose and the specific requirements of sections 1081 to 1083, inclusive, are clearly met, the recognition of gain or loss upon the exchange, sale, or distribution will not be postponed under those sections. Moreover, even though a taxable transaction occurs in connection or simultaneously with a realization of gain or loss to which nonrecognition is accorded, nevertheless, nonrecognition will not be accorded to such taxable transaction. In other words, the provisions of section 1081 do not extend in any case to gain or loss other than that realized from and directly attributable to a disposition of property as

such, or the receipt of a corporate distribution as such, in an exchange, sale, or distribution specifically described in section 1081.

(d) The application of the provisions of sections 1081 to 1083, inclusive, is intended to result only in postponing the recognition of gain or loss until a disposition of property is made which is not covered by such provisions, and, in the case of an exchange or sale subject to the provisions of section 1081(b), in the reduction of basis of certain property. The provisions of section 1082 with respect to the continuation of basis and the reduction in basis are designed to effect these results. Although the time of recognition may be shifted, there must be a true reflection of income in all cases, and it is intended that the provisions of sections 1081 to 1083, inclusive, shall not be construed or applied in such a way as to defeat this purpose.

§ 1.1081–3 Exchanges of Stock or Securities Solely for Stock or Securities.—The exchange, without the recognition of gain or loss, that is provided for in section 1081(a) must be one in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary company are exchanged solely for stock or securities other than stock or securities which constitute nonexempt property. An exchange is not within the provisions of section 1081(a) unless the stock or securities transferred and those received are stock or securities as defined by section 1083(f). The stock or securities which may be received without the recognition of gain or loss are not limited to stock or securities in the corporation from which they are received. An exchange within the provisions of section 1081(a) may be a transaction between the holder of stock or securities and the corporation which issued the stock or securities. Also the exchange may be made by a holder of stock or securities with an associate company (i. e., a corporation in the same holding company system with the issuing corporation) which is a registered holding company or a majority-owned subsidiary company. In either case, the nonrecognition provisions of section 1081(a) apply only to the holder of the stock or securities. However, the transferee corporation must be acting in obedience to an order of the Securities and Exchange Commission directed to such corporation, if no gain or loss is to be recognized to the holder of the stock or securities who makes the exchange with such corporation. See also section 1081(b), in case the holder of the stock or securities is a registered holding company or an associate company of a registered holding company. An exchange is not within the provisions of section 1081(a) if it is within the provisions of section 1081(d), relating to transfers within a system group. For treatment when nonexempt property is received, see section 1081(e); for further limitations, see section 1081(f).

§ 1.1081–4 Exchanges of Property for Property by Corporations.—(a) *Application of section 1081(b).*—Section 1081(b) applies only to the transfers specified therein with respect to which section 1081(d) is inapplicable, and deals only with such transfers if gain is realized upon the sale or other disposition effected by such transfers. If loss is realized section 1081(b) is inapplicable and the application of other provisions of subtitle A must be determined. See section 1081(g). If section 1081(b) is applicable, the other provisions of subchapters C and O relating to the nonrecognition of gain

are inapplicable, and the conditions under which, and the extent to which, the realized gain is not recognized are set forth in paragraphs (b), (c), (d), (e), and (f) of this section.

(b) *Nonrecognition of gain; no nonexempt proceeds.*—No gain is recognized to a transferor corporation upon the sale or other disposition of property transferred by such transferor corporation in exchange solely for property other than nonexempt property, as defined in section 1083(e), but only if all of the following requirements are satisfied:

(1) The transferor corporation is, under the definition in section 1083(b), a registered holding company or an associate company of a registered holding company;

(2) Such transfer is in obedience to an order of the Securities and Exchange Commission (as defined in section 1083(a)) and such order satisfies the requirements of section 1081(f);

(3) The transferor corporation has filed the required consent to the regulations under section 1082(a)(2) (see paragraph (g) of this section); and

(4) The entire amount of the gain, as determined under section 1001, can be applied in reduction of basis under section 1082(a)(2).

(c) *Nonrecognition of gain; nonexempt proceeds.*—If the transaction would be within the provisions of paragraph (b) of this section if it were not for the fact that the property received in exchange consists in whole or in part of nonexempt property (as defined in section 1083(e)), then no gain is recognized if such nonexempt property, or an amount equal to the fair market value of such nonexempt property at the time of the transfer,

(1) Is expended within the required 24-month period for property other than nonexempt property; or

(2) Is invested within the required 24-month period as a contribution to the captial, or as paid-in surplus, of another corporation;

but only if the expediture or investment is made

(3) In accordance with an order of the Securities and Exchange Commission (as defined in section 1083(a)) which satisfies the requirements of section 1081(f) and which recites that such expenditure or investment by the transferor corporation is necessary or appropriate to the integration or simplification of the holding company system of which the transferor corporation is a member; and

(4) The required consent, waiver, and bond have been executed and filed. See paragraphs (g) and (h) of this section.

(d) *Recognition of gain in part; insufficient expenditure or investment in case of nonexempt proceeds.*—If the transaction would be within the provisions of paragraph (c) of this section if it were not for the fact that the amount expended or invested is less than the fair market value of the nonexempt property received in exchange, then the gain, if any, is recognized, but in an amount not in excess of the amount by which the fair market value of such nonexempt property at the time of the transfer exceeds the amount so expended and invested.

(e) *Items treated as expenditures for the purpose of paragraphs (c) and (d) of this section.*—For the purposes of paragraphs (c) and (d) of this section, the following are treated as expenditures for property other than nonexempt property:

(1) A distribution in cancellation or redemption (except a distribution having the effect of a dividend) of the whole or a part of the transferor's own stock (not acquired on the transfer);

(2) A payment in complete or partial retirement or cancellation of securities representing indebtedness of the transferor or a complete or partial retirement or cancellation of such securities which is a part of the consideration for the transfer; and

(3) If, on the transfer, a liability of the transferor is assumed, or property of the transferor is transferred subject to a liability, the amount of such liability.

(f) *Recognition of gain in part; inability to reduce basis.*—If the transaction would be within the provisions of paragraph (b) or (c) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the amount which cannot be so applied in reduction of basis. If the transaction would be within the provisions of paragraph (d) of this section, if it were not for the fact that an amount of gain cannot be applied in reduction of basis under section 1082(a)(2), then the gain, if any, is recognized, but in an amount not in excess of the aggregate of—

(1) The amount of gain which would be recognized under paragraph (d) of this section if there were no inability to reduce basis under section 1082(a)(2); and

(2) The amount of gain which cannot be applied in reduction of basis under section 1082(a)(2).

(g) *Consent to regulations under section 1082(a)(2).*—To be entitled to the benefits of the provisions of section 1081(b), a corporation must file with its return for the taxable year in which the transfer occurs a consent to have the basis of its property adjusted under section 1082(a)(2) (see § 1.1082–3), in accordance with the provisions of the regulations in effect at the time of filing of the return for the taxable year in which the transfer occurs. Such consent shall be made in duplicate on Form 982A in accordance with these regulations and instructions on the form or issued therewith.

(h) *Requirements with respect to expenditure or investment.*—If the full amount of the expenditure or investment required for the application of paragraph (c) of this section has not been made by the close of the taxable year in which such transfer occurred, the taxpayer shall file with the return for such year an application for the benefit of the 24-month period for expenditure and investment, reciting the nature and time of the proposed expenditure or investment. When requested by the district director of internal revenue, the taxpayer shall execute and file (at such time and in such form) such waiver of the statute of limitations with respect to the assessment of deficiencies (for the taxable year of the transfer and for all succeeding taxable years in any of which falls any part of the period beginning with the

date of the transfer and ending 24 months thereafter) as the district director may specify, and such bond with such surety as the district director may require, in an amount not in excess of double the estimated maximum income tax which would be payable if the corporation does not make the required expenditure or investment within the required 24-month period.

§ 1.1081–5 DISTRIBUTION SOLELY OF STOCK OR SECURITIES.—(a) *In general.*—If, without any surrender of his stock or securities as defined in section 1083(f), a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company receives stock or securities in such corporation or owned by such corporation, no gain to the shareholder will be recognized with respect to the stock or securities received by such shareholder which do not constitute nonexempt property, if the distribution to such shareholder is made by the distributing corporation in obedience to an order of the Securities and Exchange Commission directed to such corporation. A distribution is not within the provisions of section 1081(c)(1) if it is within the provisions of section 1081(d), relating to transfers within a system group. A distribution is also not within the provisions of section 1081(c)(1) if it involves a surrender by the shareholder of stock or securities or a transfer by the shareholder of property in exchange for the stock or securities received by the shareholder. For further limitations, see section 1081(f).

(b) *Special rule.*—(1) If there is distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, no gain to the shareholder from the receipt of the rights shall be recognized, but only if all the following requirements are met:

(i) The rights are received by the shareholder without the surrender by the shareholder of any stock in the distributing corporation,

(ii) Such distribution is in accordance with an arrangement forming a ground for an order of the Securities and Exchange Commission issued pursuant to section 3 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79c) that the distributing corporation is exempt from any provision or provisions of such Act, and

(iii) Before January 1, 1958, the distributing corporation disposes of all the common stock in the second corporation which it owns.

(2) The distributing corporation shall, as soon as practicable, notify the district director of internal revenue in whose district the corporation's income tax return and supporting data was filed (see paragraph (g) of § 1.1081–11), as to whether or not requirement (iii) of subparagraph (b)(1) of this paragraph has been met. If such requirement has not been met, the periods of limitation (sections 6501 and 6502) with respect to any deficiency, including interest and additions to the tax, resulting solely from the receipt of such rights to acquire stock, shall include one year immediately following the date of such notification; and assessment and collection shall be made notwithstanding any provisions of law or rule of law which would otherwise prevent such assessment and collection.

§ 1.1081–6 Transfers Within System Group.—(a) The nonrecognition of gain or loss provided for in section 1081(d)(1) is applicable to an exchange of property for other property (including money and other nonexempt property) between corporations which are all members of the same system group. The term "system group" is defined in section 1083(d).

(b) Section 1081(d)(1) also provides for nonrecognition of gain to a corporation which is a member of a system group if property (including money or other nonexempt property) is distributed to such corporation as a shareholder in a corporation which is a member of the same system group, without the surrender by such shareholder of stock or securities in the distributing corporation.

(c) As stated in § 1.1081–2, nonrecognition of gain or loss will not be accorded to a transaction not clearly provided for in sections 1081 to 1083, inclusive, even though such transaction occurs simultaneously or in connection with an exchange, sale, or distribution to which nonrecognition is specifically accorded. Therefore, nonrecognition will not be accorded to any gain or loss realized from the discharge, or the removal of the burden, of the pecuniary obligations of a member of a system group, even though such obligations are acquired upon a transfer or distribution specifically described in section 1081(d)(1); but the fact that the acquisition of such obligations was upon a transfer or distribution specifically described in section 1081(d)(1) will, because of the basis provisions of section 1082(d), affect the cost to the member of such discharge or its equivalent. Thus, section 1081 (d)(1) does not provide for the nonrecognition of any gain or loss realized from the discharge of the indebtedness of a member of a system group as the result of the acquisition in exchange, sale, or distribution of its own bonds, notes, or other evidences of indebtedness which were acquired by another member of the same system group for a consideration less or more than the issuing price thereof (with proper adjustments for amortization of premiums or discounts).

(d) The provisions of paragraph (c) of this section may be illustrated by the following example:

Example. Suppose that the A Corporation and the B Corporation are both members of the same system group; that the A Corporation holds at a cost of $900 a bond issued by the B Corporation at par, $1,000; and that the A Corporation and the B Corporation enter into an exchange subject to the provisions of section 1081(d)(1) in which the $1,000 bond of the B Corporation is transferred from the A Corporation to the B Corporation. The $900 basis reflecting the cost to the A Corporation which would have been the basis available to the B Corporation if the property transferred to it had been something other than its own securities (see § 1.1082–6) will, in this type of transaction, reflect the cost to the B Corporation of effecting a retirement of its own $1,000 bond. The $100 gain of the B Corporation reflected in the retirement will therefore be recognized.

(e) No exchange or distribution may be made without the recognition of gain or loss as provided for in section 1081(d)(1), unless all the corporations which are parties to such exchange or distribution

are acting in obedience to an order of the Securities and Exchange Commission. If an exchange or distribution is within the provisions of section 1081(d)(1) and also may be considered to be within some other provisions of section 1081, it shall be considered that only the provisions of section 1081(d)(1) apply and that the nonrecognition of gain or loss upon such exchange or distribution is by virtue of that section.

§ 1.1081–7 SALE OF STOCK OR SECURITIES RECEIVED UPON EXCHANGE BY MEMBERS OF SYSTEM GROUP.—(a) Section 1081(d)(2) provides that to the extent that property received upon an exchange by corporations which are members of the same system group consists of stock or securities issued by the corporation from which such property was received, such stock or securities may, under certain specifically described circumstances, be sold to a party not a member of the system group, without the recognition of gain or loss to the selling corporation. The nonrecognition of gain or loss is limited, in the case of stock, to a sale of stock which is preferred as to both dividends and assets. The stock or securities must have been received upon an exchange with respect to which section 1081(d)(1) operated to prevent recognition of gain or loss to any party to the exchange. Nonrecognition of gain or loss upon the sale of such stock or securities is permitted only if the proceeds derived from the sale are applied in retirement or cancellation of stock or securities of the selling corporation which were outstanding at the time the exchange was made. It is also essential to nonrecognition of gain or loss upon the sale that both the sale of the stock or securities and the application of the proceeds derived therefrom be made in obedience to an order of the Securities and Exchange Commission. If any part of the proceeds derived from the sale is not applied in making the required retirement or cancellation of stock or securities and if the sale is otherwise within the provisions of section 1081(d)(2), the gain resulting from the sale shall be recognized, but in an amount not in excess of the proceeds which are not so applied. In any event, if the proceeds derived from the sale of the stock or securities exceed the fair market value of such stock or securities at the time of the exchange through which they were acquired by the selling corporation, the gain resulting from the sale is to be recognized to the extent of such excess. Section 1081(d)(2) does not provide for the nonrecognition of any gain resulting from the retirement of bonds, notes, or other evidences of indebtedness for a consideration less than the issuing price thereof. Also, that section does not provide for the nonrecognition of gain or loss upon the sale of any stock or securities received upon a distribution or otherwise than upon an exchange.

(b) The application of paragraph (a) of this section may be illustrated by the following example:

Example. The X Corporation and the Y Corporation, both of which make their income tax returns on a calendar year basis, are members of the same system group. As part of an exchange to which section 1081(d)(1) is applicable the Y Corporation on June 1, 1954, issued to the X Corporation 1,000 shares of class A stock, preferred as to both dividends and assets. The fair market value

of such stock at the time of issuance was $90,000 and its basis to the X Corporation was $75,000. On December 1, 1954, in obedience to an appropriate order of the Securities and Exchange Commission, the X Corporation sells all of such stock to the public for $100,000 and applies $95,000 of this amount to the retirement of its own bonds, which were outstanding on June 1, 1954. The remaining $5,000 is not used to retire any of the X Corporation's stock or securities. Of the total gain of $25,000 realized on the disposition of the Y Corporation stock, only $10,000 is recognized (the difference between the fair market value of the stock when acquired and the amount for which it was sold), since such amount is greater than the portion ($5,000) of the proceeds not applied to the retirement of the X Corporation's stock or securities. If in this example the stock acquired by the X Corporation had not been stock of the Y Corporation issued to the X Corporation or if it had been stock not preferred as to both dividends and assets, the full amount of the gain ($25,000) realized upon its disposition would have been recognized, regardless of what was done with the proceeds.

§ 1.1081–8 Exchanges in Which Money or Other Nonexempt Property Is Received.—(a) Under section 1081(e)(1), if in any exchange (not within any of the provisions of section 1081(d)) in which stock or securities in a corporation which is a registered holding company or a majority-owned subsidiary are exchanged for stock or securities as provided for in section 1081(a), there is received by the taxpayer money or other nonexempt property (in addition to property permitted to be received without recognition of gain), then—

(1) The gain, if any, to the taxpayer is to be recognized in an amount not in excess of the sum of the money and the fair market value of the other nonexempt property, but

(2) The loss, if any, to the taxpayer from such an exchange is not to be recognized to any extent.

(b) If money or other nonexempt property is received from a corporation in an exchange described in paragraph (a) of this section and if the distribution of such money or other nonexempt property by or on behalf of such corporation has the effect of the distribution of a taxable dividend, then, as provided in section 1081(e)(2), there shall be taxed to each distributee (1) as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and (2) the remainder of the gain so recognized shall be taxed as a gain from the exchange of property.

§ 1.1081–9 Requirements With Respect to Order of Securities and Exchange Commission.—The term "order of the Securities and Exchange Commission" is defined in section 1083(a). In addition to the requirements specified in that definition, section 1081(f) provides that, except in the case of a distribution described in section 1081(c)(2), the provisions of section 1081 shall not apply to an exchange, expenditure, investment, distribution, or sale unless each of the following requirements is met:

(a) The order of the Securities and Exchange Commission must recite that the exchange, expenditure, investment, distribution, or sale is necessary or appropriate to effectuate the provisions of section 11(b) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k(b)).

(b) The order shall specify and itemize the stocks and securities and other property (including money) which are ordered to be acquired, transferred, received, or sold upon such exchange, acquisition, expenditure, distribution, or sale and, in the case of an investment, the investment to be made, so as clearly to identify such property.

(c) The exchange, acquisition, expenditure, investment, distribution, or sale shall be made in obedience to such order and shall be completed within the time prescribed in such order.

These requirements were not designed merely to simplify the administration of the provisions of section 1081, and they are not to be considered as pertaining only to administrative matters. Each one of the three requirements is essential and must be met if gain or loss is not to be recognized upon the transaction.

§ 1.1081–10 NONAPPLICATION OF OTHER PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954.—The effect of section 1081(g) is that an exchange, sale, or distribution which is within section 1081 shall, with respect to the nonrecognition of gain or loss and the determination of basis, be governed only by sections 1081 to 1083, inclusive, the purpose being to prevent overlapping of the provisions of such sections and other provisions of subtitle A. In other words, if by virtue of section 1081 any portion of a person's gain or loss on any particular exchange, sale, or distribution is not to be recognized, then the gain or loss of such person shall be nonrecognized only to the extent provided in section 1081, regardless of what the result might have been if sections 1081 to 1083, inclusive, had not been enacted; and similarly, the basis in the hands of such person of the property received by him in such transaction shall be the basis provided by section 1082, regardless of what the basis of such property might have been under section 1011 if sections 1081 to 1083, inclusive, had not been enacted. On the other hand, if section 1081 does not provide for the nonrecognition of any portion of a person's gain or loss (whether or not such person is another party to the same transaction referred to above), then the gain or loss of such person shall be recognized or nonrecognized to the extent provided for by other provisions of subtitle A as if sections 1081 to 1083, inclusive, had not been enacted; and similarly, the basis in his hands of the property received by him in such transaction shall be the basis provided by other provisions of subtitle A as if sections 1081 to 1083, inclusive, had not been enacted.

§ 1.1081–11 RECORDS TO BE KEPT AND INFORMATION TO BE FILED WITH RETURNS.—(a) *Exchanges; holders of stock or securities.*— Every holder of stock or securities who receives stock or securities and other property (including money) upon an exchange shall, if the exchange is made with a corporation acting in obedience to an order of the Securities and Exchange Commission, file as a part of his income tax return for the taxable year in which the exchange takes place a

complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A clear description of the stock or securities transferred in the exchange, together with a statement of the cost or other basis of such stock or securities.

(2) The name and address of the corporation from which the stock or securities were received in the exchange.

(3) A statement of the amount of stock or securities and other property (including money) received from the exchange. The amount of each kind of stock or securities and other property received shall be set forth upon the basis of the fair market value thereof at the date of the exchange.

(b) *Exchanges; corporations subject to S. E. C. orders.*—Each corporation which is a party to an exchange made in obedience to an order of the Securities and Exchange Commission directed to such corporation shall file as a part of its income tax return for its taxable year in which the exchange takes place a complete statement of all facts pertinent to the nonrecognition of gain or loss upon such exchange, including—

(1) A copy of the order of the Securities and Exchange Commission directed to such corporation, in obedience to which the exchange was made.

(2) A certified copy of the corporate resolution authorizing the exchange.

(3) A clear description of all property, including all stock or securities, transferred in the exchange, together with a complete statement of the cost or other basis of each class of property.

(4) The date of acquisition of any stock or securities transferred in the exchange, and, if any of such stock or securities were acquired by the corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The name and address of all persons to whom any property was transferred in the exchange.

(6) If any property transferred in the exchange was transferred to another corporation, a copy of any order of the Securities and Exchange Commission directed to the other corporation, in obedience to which the exchange was made by such other corporation.

(7) If the corporation transfers any nonexempt property, the amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the exchange, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(8) A statement of the amount of stock or securities and other property (including money) received upon the exchange, including a statement of all distributions or other dispositions made thereof. The amount of each kind of stock or securities and other property received shall be stated on the basis of the fair market value thereof at the date of the exchange.

(9) A statement showing as to each class of its stock the number of shares and percentage owned by any other corporation,

the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(10) The term "exchange" shall, whenever occurring in this paragraph, be read as "exchange, expenditure, or investment."

(c) *Distributions; shareholders.*—Each share holder who receives stock or securities or other property (including money) upon a distribution made by a corporation in obedience to an order of the Securities and Exchange Commission shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of stock or securities or other property received upon the distribution, including (in case the shareholder is a corporation) a statement of all distributions or other disposition made of such stock or securities or other property by the shareholder. The amount of each class of stock or securities and each kind of property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(3) If the shareholder is a corporation, a statement showing as to each class of its stock the number of shares and percentage owned by a registered holding company or a majority-owned subsidiary company of a registered holding company, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(d) *Distributions; distributing corporation subject to S. E. C. orders.*—Every corporation making a distribution in obedience to an order of the Securities and Exchange Commission shall file as a part of its income tax return for its taxable year in which the distribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributee upon such distribution including—

(1) A copy of the order of the Securities and Exchange Commission, in obedience to which the distribution was made.

(2) A certified copy of the corporate resolution authorizing the distribution.

(3) A statement of the amount of stock or securities or other property (including money) distributed to each shareholder. The amount of each kind of stock or securities or other property shall be stated on the basis of the fair market value thereof at the date of the distribution.

(4) The date of acquisition of the stock or securities distributed, and, if any of such stock or securities were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(5) The amount of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(6) A statement showing as to each class of its stock the number

of shares and percentage owned by any other corporation, the voting rights and voting power, and the preference (if any) as to both dividends and assets.

(e) *Sales by members of system groups.*—Each corporation which is a member of a system group and which in obedience to an order of the Securities and Exchange Commission sells stock or securities received upon an exchange (made in obedience to an order of the Securities and Exchange Commission) and applies the proceeds derived therefrom in retirement or cancellation of its own stock or securities shall file as a part of its income tax return for the taxable year in which the sale is made a complete statement of all facts pertaining to the nonrecognition of gain or loss upon such sale, including—

(1) A copy of the order of the Securities and Exchange Commission in obedience to which the sale was made.

(2) A copy of the order of the Securities and Exchange Commission in obedience to which the proceeds derived from the sale were applied in whole or in part in the retirement or cancellation of its stock or securities.

(3) A certified copy of the corporate resolutions authorizing the sale of the stock or securities and the application of the proceeds derived therefrom.

(4) A clear description of the stock or securities sold, including the name and address of the corporation by which they were issued.

(5) The date of acquisition of the stock or securities sold, together with a statement of the fair market value of such stock or securities at the date of acquisition, and a copy of all orders of the Securities and Exchange Commission in obedience to which such stock or securities were acquired.

(6) The amount of the proceeds derived from such sale.

(7) The portion of the proceeds of such sale which was applied in retirement or cancellation of its stock or securities, together with a statement showing how long such stock or securities were outstanding prior to retirement or cancellation.

(8) The issuing price of its stock or securities which were retired or canceled.

(f) *Section 1081(c)(2) distributions; shareholders.*—Each shareholder who receives a distribution described in section 1081(c)(2) (concerning rights to acquire common stock) shall file as a part of his income tax return for the taxable year in which such distribution is received a complete statement of all the facts pertinent to the nonrecognition of gain upon such distribution, including—

(1) The name and address of the corporation from which the distribution is received.

(2) A statement of the amount of the rights received upon the distribution, stated on the basis of their fair market value at the date of the distribution.

(g) *Section 1081(c)(2) distributions; distributing corporations.*—Every corporation making a distribution described in section 1081(c)(2) (concerning rights to acquire common stock) shall file as a part of its income tax return for its taxable year in which the dis-

tribution is made a complete statement of all facts pertinent to the nonrecognition of gain to the distributees upon such distribution including—

(1) A copy of the arrangement forming the basis for the issuance of the order by the Securities and Exchange Commission.

(2) A copy of the order issued by the Securities and Exchange Commission pursuant to section 3 of the Public Utility Holding Company Act of 1935.

(3) A certified copy of the corporate resolution authorizing the arrangement and the distribution.

(4) A statement of the amount of the rights distributed to each shareholder, stated on the basis of their fair market value at the date of the distribution.

(5) The date of acquisition of the stock with respect to which such rights are distributed, and, if any were acquired by the distributing corporation in obedience to an order of the Securities and Exchange Commission, a copy of such order.

(6) The amount of the undistributed earnings and profits of the distributing corporation accumulated after February 28, 1913, to the time of the distribution, computed in accordance with the last sentence in paragraph (b) of § 1.316–2.

(h) *General requirements.*—Permanent records in substantial form shall be kept by every taxpayer who participates in an exchange or distribution to which sections 1081 to 1083, inclusive, are applicable, showing the cost or other basis of the property transferred and the amount of stock or securities and other property (including money) received, in order to facilitate the determination of gain or loss from a subsequent disposition of such stock or securities and other property received on the exchange or distribution.

§ 1.1082 STATUTORY PROVISIONS; BASIS OF PROPERTY ACQUIRED IN EXCHANGES AND DISTRIBUTIONS MADE IN OBEDIENCE TO ORDERS OF THE SECURITIES AND EXCHANGE COMMISSION.

SEC. 1082. BASIS FOR DETERMINING GAIN OR LOSS.

(a) EXCHANGES GENERALLY.—

(1) EXCHANGES SUBJECT TO THE PROVISIONS OF SECTION 1081(a) OR (e).—If the property was acquired on an exchange subject to the provisions of section 1081(a) or (e), or the corresponding provisions of prior internal revenue laws, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer, and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 1081(a) to be received without the recognition of gain or loss, and in part of nonexempt property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange. This subsection shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(2) EXCHANGES SUBJECT TO THE PROVISIONS OF SECTION 1081(b).—The gain not recognized on a transfer by reason of section 1081(b) or the

corresponding provisions of prior internal revenue laws shall be applied to reduce the basis for determining gain or loss on sale or exchange of the following categories of property in the hands of the transferor immediately after the transfer, and property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates on account of the acquisition of which gain is not recognized under such subsection, in the following order:

(A) property of a character subject to the allowance for depreciation under section 167;

(B) property (not described in subparagraph (A)) with respect to which a deduction for amortization is allowable under section 168 or 169;

(C) property with respect to which a deduction for depletion is allowable under section 611 but not allowable under section 613;

(D) stock and securities of corporations not members of the system group of which the transferor is a member (other than stock or securities of a corporation of which the transferor is a subsidiary);

(E) securities (other than stock) of corporations which are members of the system group of which the transferor is a member (other than securities of the transferor or of a corporation of which the transferor is a subsidiary);

(F) stock of corporations which are members of the system group of which the transferor is a member (other than stock of the transferor or of a corporation of which the transferor is a subsidiary);

(G) all other remaining property of the transferor (other than stock or securities of the transferor or of a corporation of which the transferor is a subsidiary).

The manner and amount of the reduction to be applied to particular property within any of the categories described in subparagraphs (A) to (G), inclusive, shall be determined under regulations prescribed by the Secretary or his delegate.

(3) Basis in case of pre-1942 acquisition.—Notwithstanding the provisions of paragraph (1) or (2), if the property was acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 before its amendment by the Revenue Act of 1942, the basis shall be that prescribed in such section (before its amendment by such Act) with respect to such property.

(b) Transfers to Corporations.—If, in connection with a transfer subject to the provisions of section 1081(a), (b), or (e) or the corresponding provisions of prior internal revenue laws, the property was acquired by a corporation, either as paid-in surplus or as a contribution to capital, or in consideration for stock or securities issued by the corporation receiving the property (including cases where part of the consideration for the transfer of such property to the corporation consisted of property or money in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor on such transfer under the law applicable to the year in which the transfer was made.

(c) Distributions of Stock or Securities.—If the stock or securities were received in a distribution subject to the provisions of section 1081(c) or the corresponding provisions of prior internal revenue laws, then the basis in the case of the stock in respect of which the distribution was made shall be apportioned, under regulations prescribed by the Secretary or his delegate, between such stock and the stock or securities distributed.

(d) Transfers Within System Group.—If the property was acquired by a corporation which is a member of a system group on a transfer or distribution described in section 1081(d)(1), then the basis shall be the same as it would be in the hands of the transferor; except that if such property is stock or securities issued by the corporation from which such stock or securities were received and they were issued—

(1) as the sole consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either—

(A) the same as in the case of the property transferred therefor, or

(B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower; or

(2) as part consideration for the property transferred to such corporation, then the basis of such stock or securities shall be either—

(A) an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities at the time of their receipt bears to the total fair market value of the entire consideration received, or

(B) the fair market value of such stock or securities at the time of their receipt, whichever is the lower.

§ 1.1082–1 Basis for Determining Gain or Loss.—(a) For determining the basis of property acquired in a taxable year beginning before January 1, 1942, in any manner described in section 372 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942, see such section (before its amendment by such Act).

(b) If the property was acquired in a taxable year beginning after December 31, 1941, in any manner described in section 1082 (other than subsection (a)(2)), or section 372 (other than subsection (a)(2)) of the Internal Revenue Code of 1939 after its amendments, the basis shall be that prescribed in section 1082 with respect to such property. However, in the case of property acquired in a transaction described in section 1081(c)(2), this paragraph is applicable only if the property was acquired in a distribution made in a taxable year subject to the Internal Revenue Code of 1954.

(c) Section 1082 makes provisions with respect to the basis of property acquired in a transfer in connection with which the recognition of gain or loss is prohibited by the provisions of section 1081 with respect to the whole or any part of the property received. In general, and except as provided in § 1.1082–3, it is intended that the basis for determining gain or loss pertaining to the property prior to its transfer, as well as the basis for determining the amount of depreciation or depletion deductible and the amount of earnings or profits available for distribution, shall continue notwithstanding the nontaxable conversion of the asset in form or its change in ownership. The continuance of the basis may be reflected in a shift thereof from one asset to another in the hands of the same owner, or in its transfer with the property from one owner into the hands of another. See also § 1.1081–2.

§ 1.1082–2 Basis of Property Acquired Upon Exchanges Under Section 1081(a) or (e).—(a) In the case of an exchange of stock or securities for stock or securities as described in section 1081(a), if no part of the gain or loss upon such exchange was recognized under section 1081, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange.

(b) If, in an exchange of stock or securities as described in section 1081(a), gain to the taxpayer was recognized under section 1081(e) on account of the receipt of money, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized upon the exchange. If, upon such exchange, there were received by the taxpayer money and other non-

exempt property (not permitted to be received without the recognition of gain), and gain from the transaction was recognized under section 1081(e), the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of money received and increased by the amount of gain recognized, must be apportioned to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of such basis to the properties received, there must be assigned to the nonexempt property (other than money) an amount equivalent to its fair market value at the date of the exchange.

(c) Section 1081(e) provides that no loss may be recognized on an exchange of stock or securities for stock or securities as described in section 1081(a), although the taxpayer receives money or other nonexempt property from the transaction. However, the basis of the property (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred decreased by the amount of money received. The basis must be apportioned to the properties received, and for this purpose there must be allocated to the nonexempt property (other than money) an amount of such basis equivalent to the fair market value of such nonexempt property at the date of the exchange.

(d) Section 1082(a) does not apply in ascertaining the basis of property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it. For the rule in such cases, see section 1082(b).

(e) For purposes of this section, any reference to section 1081 shall be deemed to include a reference to corresponding provisions of prior internal revenue laws.

§ 1.1082–3 Reduction of Basis of Property by Reason of Gain Not Recognized Under Section 1081(b).—(a) *Introductory.*—In addition to the adjustments provided in section 1016 and other applicable provisions of chapter 1, and the regulations relating thereto, which are required to be made with respect to the cost or other basis of property, section 1082(a)(2) provides that a further adjustment shall be made in any case in which there shall have been a nonrecognition of gain under section 1081(b). Such further adjustment shall be made with respect to the basis of the property in the hands of the transferor immediately after the transfer and of the property acquired within 24 months after such transfer by an expenditure or investment to which section 1081(b) relates, and on account of which expenditure or investment gain is not recognized. If the property is in the hands of the transferor immediately after the transfer, the time of reduction is the day of the transfer; in all other cases the time of reduction is the date of acquisition. The effect of applying an amount in reduction of basis of property under section 1081(b) is to reduce by such amount the basis for determining gain upon sale or other disposition, the basis for determining loss upon sale or other disposition, the basis for depreciation and for depletion, and any other amount which the Internal Revenue Code of 1954 prescribes shall be the same as any of such bases. For the purposes of the application of an amount in reduction of basis under section 1081(b), property is not considered as having a basis capable of reduction if—

(1) It is money, or

(2) If its adjusted basis for determining gain at the time the reduction is to be made is zero, or becomes zero at any time in the application of section 1081(b).

(b) *General rule.*—(1) Section 1082(a)(2) sets forth seven categories of property, the basis of which for determining gain or loss shall be reduced in the order stated.

(2) If any of the property in the first category has a basis capable of reduction, the reduction must first be made before applying an amount in reduction of the basis of any property in the second or in a succeeding category, to each of which in turn a similar rule is applied.

(3) In the application of the rule to each category, the amount of the gain not recognized shall be applied to reduce the cost or other basis of all the property in the category as follows: The cost or other basis (at the time immediately after the transfer or, if the property is not then held but is thereafter acquired, at the time of such acquisition) of each unit of property in the first category shall be decreased (but the amount of the decrease shall not be more than the amount of the adjusted basis at such time for determining gain, determined without regard to this section) in an amount equal to such proportion of the unrecognized gain as the adjusted basis (for determining gain, determined without regard to this section) at such time of each unit of property of the taxpayer in that category bears to the aggregate of the adjusted basis (for determining gain, computed without regard to this section) at such time of all the property of the taxpayer in that category. When such adjusted basis of the property in the first category has been thus reduced to zero, a similar rule shall be applied, with respect to the portion of such gain which is unabsorbed in such reduction of the basis of the property in such category, in reducing the basis of the property in the second category. A similar rule with respect to the remaining unabsorbed gain shall be applied in reducing the basis of the property in the next succeeding category.

(c) *Special cases.*—(1) With the consent of the Commissioner, the taxpayer may, however, have the basis of the various units of property within a particular category specified in section 1082(a)(2) adjusted in a manner different from the general rule set forth in paragraph (b) of this section. Variations from such general rule may, for example, involve adjusting the basis of only certain units of the taxpayer's property within a given category. A request for variations from the general rule should be filed by the taxpayer with its income tax return for the taxable year in which the transfer of property has occurred.

(2) Agreement between the taxpayer and the Commissioner as to any variations from such general rule shall be effective only if incorporated in a closing agreement entered into under the provisions of section 7121. If no such agreement is entered into by the taxpayer and the Commissioner, then the consent filed on Form 982A shall (except as otherwise provided in this subparagraph) be deemed to be a consent to the application of such general rule, and such general rule shall apply in the determination of the basis of the taxpayer's property. If, however, the taxpayer specifically states on such form that

it does not consent to the application of the general rule, then, in the absence of a closing agreement, the document filed shall not be deemed a consent within the meaning of section 1081(b)(4).

§ 1.1082–4 Basis of Property Acquired by Corporation Under Section 1081(a), 1081(b), or 1081(e) as Contribution of Capital or Surplus, or in Consideration for Its Own Stock or Securities.—If, in connection with an exchange of stock or securities for stock or securities as described in section 1081(a), or an exchange of property for property as described in section 1081(b), or an exchange as described in section 1081(e), property is acquired by a corporation by the issuance of its stock or securities, the basis of such property shall be determined under section 1082(b). If the corporation issued its stock or securities as part or sole consideration for the property acquired, the basis of the property in the hands of the acquiring corporation is the basis (adjusted to the date of the exchange) which the property would have had in the hands of the transferor if the transfer had not been made, increased in the amount of gain or decreased in the amount of loss recognized under section 1081 to the transferor upon the transfer. If any property is acquired by a corporation from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property to the corporation is the basis (adjusted to the date of acquisition) of the property in the hands of the transferor.

§ 1.1082–5 Basis of Property Acquired by Shareholder Upon Tax-Free Distribution Under Section 1081(c)(1) or (2).—(a) *Stock or securities.*—If there was distributed to a shareholder in a corporation which is a registered holding company or a majority-owned subsidiary company, stock or securities (other than stock or securities which are nonexempt property), and if by virtue of section 1081(c)(1) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock or securities so distributed to the shareholder. The basis of the old shares and the stock or securities received upon the distribution shall be determined in accordance with the following rules:

(1) If the stock or securities received upon the distribution consists solely of stock in the distributing corporation and the stock received is all of substantially the same character and preference as the stock in respect of which the distribution is made, the basis of each share will be the quotient of the cost or other basis of the old shares of stock divided by the total number of the old and the new shares.

(2) If the stock or securities received upon the distribution are in whole or in part stock in a corporation other than the distributing corporation, or are in whole or in part stock of a character or preference materially different from the stock in respect of which the distribution is made, or if the distribution consists in whole or in part of securities other than stock, the cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock or securities distributed in proportion, as nearly as may be, to the respective values

of each class of stock or security, old and new, at the time of such distribution, and the basis of each share of stock or unit of security will be the quotient of the cost or other basis of the class of stock or security to which such share or unit belongs, divided by the number of shares or units in the class. Within the meaning of this subparagraph, stocks or securities in one corporation are different in class from stocks or securities in another corporation, and, in general, any material difference in character or preference or terms sufficient to distinguish one stock or security from another stock or security, so that different values may properly be assigned thereto, will constitute a difference in class.

(b) *Stock rights.*—If there was distributed to a shareholder in a corporation rights to acquire common stock in a second corporation, and if by virtue of section 1081(c)(2) no gain was recognized to the shareholder upon such distribution, then the basis of the stock in respect of which the distribution was made must be apportioned between such stock and the stock rights so distributed to the shareholder. The basis of such stock and the stock rights received upon the distribution shall be determined in accordance with the following:

(1) The cost or other basis of the stock in respect of which the distribution is made shall be apportioned between such stock and the stock rights distributed, in proportion to the respective values thereof at the time the rights are issued.

(2) The basis for determining gain or loss from the sale of a right, or from the sale of a share of stock in respect of which the distribution is made, will be the quotient of the cost or other basis, properly adjusted, assigned to the rights or the stock, divided, as the case may be, by the number of rights acquired or by the number of shares of such stock held.

(c) *Cross reference.*—As to the basis of stock or securities distributed by one member of a system group to another member of the same system group, see § 1.1082–6.

§ 1.1082–6 Basis of Property Acquired Under Section 1081(d) in Transactions Between Corporations of the Same System Group.—(a) If property was acquired by a corporation which is a member of a system group, from a corporation which is a member of the same system group, upon a transfer or distribution described in section 1081(d)(1), then as a general rule the basis of such property in the hands of the acquiring corporation is the basis which such property would have had in the hands of the transferor if the transfer or distribution had not been made. Except as otherwise indicated in this section, this rule will apply equally to cases in which the consideration for the property acquired consists of stock or securities, money, and other property, or any of them, but it is contemplated that an ultimate true reflection of income will be obtained in all cases, notwithstanding any peculiarities in form which the various transactions may assume. See the example in § 1.1081–6.

(b) An exception to the general rule is provided for in case the property acquired consists of stock or securities issued by the corporation from which such stock or securities were received. If such stock

or securities were the sole consideration for the property transferred to the corporation issuing such stock or securities, then the basis of the stock or securities shall be (1) the same as the basis (adjusted to the time of the transfer) of the property transferred for such stock or securities, or (2) the fair market value of such stock or securities at the time of their receipt, whichever is the lower. If such stock or securities constituted only part consideration for the property transferred to the corporation issuing such stock or securities, then the basis shall be an amount which bears the same ratio to the basis of the property transferred as the fair market value of such stock or securities on their receipt bears to the total fair market value of the entire consideration received, except that the fair market value of such stock or securities at the time of their receipt shall be the basis therefor, if such value is lower than such amount.

(c) The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Suppose the A Corporation has property with an adjusted basis of $600,000 and, in an exchange in which section 1081 (d) (1) is applicable, transfers such property to the B Corporation in exchange for a total consideration of $1,000,000, consisting of (1) cash in the amount of $100,000, (2) tangible property having a fair market value of $400,000 and an adjusted basis in the hands of the B Corporation of $300,000, and (3) stock or securities issued by the B Corporation with a par value and a fair market value as of the date of their receipt in the amount of $500,000. The basis to the B Corporation of the property received by it is $600,000, which is the adjusted basis of such property in the hands of the A Corporation. The basis to the A Corporation of the assets (other than cash) received by it is as follows: Tangible property, $300,000, the adjusted basis of such property to the B Corporation, the former owner; stock or securities issued by the B Corporation, $300,000, an amount equal to 500,000/1,000,000ths of $600,000.

Example (2). Suppose that in example (1) the property of the A Corporation transferred to the B Corporation had an adjusted basis of $1,100,000 instead of $600,000, and that all other factors in the example remain the same. In such case the basis to the A Corporation of the stock or securities in the B Corporation is $500,000, which was the fair market value of such stock or securities at the time of their receipt by the A Corporation, because this amount is less than the amount established as 500,000/1,000,000ths of $1,100,-000 or $550,000.

§ 1.1083 Statutory Provisions; Exchanges and Distributions in Obedience to Orders of the Securities and Exchange Commission; Definitions.

SEC. 1083. DEFINITIONS.

(a) ORDER OF SECURITIES AND EXCHANGE COMMISSION.—For purposes of this part, the term "order of the Securities and Exchange Commission" means an order issued after May 28, 1938, by the Securities and Exchange Commission which requires, authorizes, permits, or approves transactions described in such order to effectuate section 11(b) of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k(b)), which has become or becomes final in accordance with law.

(b) REGISTERED HOLDING COMPANY; HOLDING COMPANY SYSTEM; ASSOCIATE COMPANY.—For purposes of this part, the terms "registered holding company", "holding company system", and "associate company" shall have the meanings assigned to them by section 2 of the Public Utility Holding Company Act of 1935 (49 Stat. 804; 15 U. S. C. 79b(a)).

(c) MAJORITY-OWNED SUBSIDIARY COMPANY.—For purposes of this part, the term "majority-owned subsidiary company" of a registered holding company means a corporation, stock of which, representing in the aggregate more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote (not including stock which is entitled to vote only on default or nonpayment of dividends or other special circumstances) is owned wholly by such registered holding company, or partly by such registered holding company and partly by one or more majority-owned subsidiary companies thereof, or by one or more majority-owned subsidiary companies of such registered holding company.

(d) SYSTEM GROUP.—For purposes of this part, the term "system group" means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) at least 90 percent of each class of the stock (other than (A) stock which is preferred as to both dividends and assets, and (B) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations, (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) the common parent corporation owns directly at least 90 percent of each class of the stock (other than stock, which is preferred as to both dividends and assets) of at least one of the other corporations; and

(3) each of the corporations is either a registered holding company or a majority-owned subsidiary company.

(e) NONEXEMPT PROPERTY.—For purposes of this part, the term "nonexempt property" means—

(1) any consideration in the form of evidences of indebtedness owed by the transferor or a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred);

(2) short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace;

(3) securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentaility of a government or subdivision thereof);

(4) stock or securities which were acquired from a registered holding company or an associate company of a registered holding company which acquired such stock or securities after February 28, 1938, unless such stock or securities (other than obligations described as nonexempt property in paragraph (1), (2), or (3)) were acquired in obedience to an order of the Securities and Exchange Commission or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935 (49 Stat. 820; 15 U. S. C. 79k(b));

(5) money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in paragraph (2) or (3).

(f) STOCK OR SECURITIES.—For purposes of this part, the term "stock or securities" means shares of stock in any corporation, certificates of stock or interest in any corporation, notes, bonds, debentures, and evidences of indebtedness (including any evidence of an interest in or right to subscribe to or purchase any of the foregoing).

§ 1.1083–1 DEFINITIONS.—(a) *Order of the Securities and Exchange Commission.*—(1) An order of the Securities and Exchange Commission as defined in section 1083(a) must be issued after May

28, 1938 (the date of the enactment of the Revenue Act of 1938), and must be issued under the authority of section 11(b) or 11(e) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79k (b), (e)), to effectuate the provisions of section 11(b) of such Act. In all cases the order must become or have become final in accordance with law; i. e., it must be valid, outstanding, and not subject to further appeal. See further sections 1083(a) and 1081(f).

(2) Section 11(b) of the Public Utility Holding Company Act of 1935 provides:

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

(1) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such action as the Commission shall find necessary to limit the operations of the holding-company system of which such company is a part to a single integrated public-utility system, and to such other businesses as are reasonably incidental, or economically necessary or appropriate to the operations of such integrated public-utility system: *Provided, however*, That the Commission shall permit a registered holding company to continue to control one or more additional integrated public-utility systems, if, after notice and opportunity for hearing, it finds that—

(A) Each of such additional systems cannot be operated as an independent system without the loss of substantial economies which can be secured by the retention of control by such holding company of such system;

(B) All of such additional systems are located in one State, or in adjoining States, or in a contiguous foreign country; and

(C) The continued combination of such systems under the control of such holding company is not so large (considering the state of the art and the area or region affected) as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The Commission may permit as reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems the retention of an interest in any business (other than the business of a public-utility company as such) which the Commission shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such system or systems.

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company. The Commission may by order revoke or modify any order previously made under this subsection, if, after notice and opportunity for hearing, it finds that the conditions upon which the order was predicated do not exist. Any order made under this subsection shall be subject to judicial review as provided in section 24.

§ 1.1083–1(a)(2)

(3) Section 11(e) of the Public Utility Holding Company Act of 1935 provides:

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan: and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

(b) *Registered holding company, holding-company system, and associate company.*—(1) Under section 5 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79e), any holding company may register by filing with the Securities and Exchange Commission a notification of registration, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. A holding company shall be deemed to be registered upon receipt by the Securities and Exchange Commission of such notification of registration. As used in this part, the term "registered holding company" means a holding company whose notification of registration has been so received and whose registration is still in effect under section 5 of the Public Utility Holding Company Act of 1935. Under section 2(a)(7) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(7)), a corporation is a holding company (unless it is declared not to be such by the Securities and Exchange Commission), if such corporation directly or indirectly owns, controls, or holds with power to vote 10 percent or more of the outstanding voting securities of a public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or of any other holding company. A corporation is also a holding company if the Securities and Exchange Commission determines, after notice and opportunity for hearing, that such corporation directly or indirectly exercises (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility company (i. e., an electric utility company or a gas utility company as defined by such act) or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such corporation be subject to the obligations, duties, and liabilities imposed

upon holding companies by the Public Utility Holding Company Act of 1935 (15 U. S. C. c. 2C). An electric utility company is defined by section 2(a)(3) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(3)) to mean a company which owns or operates facilities used for the generation, transmission, or distribution of electrical energy for sale, other than sale to tenants or employees of the company operating such facilities for their own use and not for resale; and a gas utility company is defined by section 2(a)(4) of such act (15 U. S. C. 79b(a)(4)), to mean a company which owns or operates facilities used for the distribution at retail (other than distribution only in enclosed portable containers, or distribution to tenants or employees of the company operating such facilities for their own use and not for resale) of natural or manufactured gas for heat, light, or power. However, under certain conditions the Securities and Exchange Commission may declare a company not to be an electric utility company or a gas utility company, as the case may be, in which event the company shall not be considered an electric utility company or a gas utility company.

(2) The term "holding company system" has the meaning assigned to it by section 2(a)(9) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(9)), and hence means any holding company, together with all its subsidiary companies (i. e., subsidiary companies within the meaning of section 2(a)(8) of such act (15 U. S. C. 79b(a)(8)), which in general include all companies 10 percent of whose outstanding voting securities is owned directly or indirectly by such holding company) and all mutual service companies of which such holding company or any subsidiary company thereof is a member company. The term "mutual service company" means a company approved as a mutual service company under section 13 of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79m). The term "member company" is defined by section 2(a)(14) of such act (15 U. S. C. 79b(a)(14)), to mean a company which is a member of an association or group of companies mutually served by a mutual service company.

(3) The term "associate company" has the meaning assigned to it by section 2(a)(10) of the Public Utility Holding Company Act of 1935 (15 U. S. C. 79b(a)(10)), and hence an associate company of a company is any company in the same holding-company system with such company.

(c) *Majority-owned subsidiary company.*—The term "majority-owned subsidiary company" is defined in section 1083(c). Direct ownership by a registered holding company of more than 50 percent of the specified stock of another corporation is not necessary to constitute such corporation a majority-owned subsidiary company. To illustrate, if the H Corporation, a registered holding company, owns 51 percent of the common stock of the A Corporation and 31 percent of the common stock of the B Corporation, and the A Corporation owns 20 percent of the common stock of the B Corporation (the common stock in each case being the only stock entitled to vote), both the A Corporation and the B Corporation are majority-owned subsidiary companies.

§ 1.1083–1(b)(2)

(d) *System group.*—The term "system group" is defined in section 1083(d) to mean one or more chains of corporations connected through stock ownership with a common parent corporation, if at least 90 percent of each class of stock (other than (1) stock which is preferred as to both dividends and assets, and (2) stock which is limited and preferred as to dividends but which is not preferred as to assets but only if the total value of such stock is less than 1 percent of the aggregate value of all classes of stock which are not preferred as to both dividends and assets) of each of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations, and if the common parent corporation owns directly at least 90 percent of each class of stock (other than stock preferred as to both dividends and assets) of at least one of the other corporations; but no corporation is a member of a system group unless it is either a registered holding company or a majority-owned subsidiary company. While the type of stock which must, for the purpose of this definition, be at least 90 percent owned may be different from the voting stock which must be more than 50 percent owned for the purpose of the definition of a majority-owned subsidiary company under section 1083(c), as a general rule both types of ownership tests must be met under section 1083(d), since a corporation, in order to be a member of a system group, must also be a registered holding company or a mjority-owned subsidiary company.

(e) *Nonexempt property.*—The term "nonexempt property" is defined by section 1083(e) to include—

(1) The amount of any consideration in the form of a cancellation or assumption of debts or other liabilities of the transferor (including a continuance of encumbrances subject to which the property was transferred). To illustrate, if in obedience to an order of the Securities and Exchange Commission the X Corporation, a registered holding company, transfers property to the Y Corporation in exchange for property (not nonexempt property) with a fair market value of $500,000, the X Corporation receives $100,000 of nonexempt property, if for example—

(i) The Y Corporation cancels $100,000 of indebtedness owed to it by the X Corporation;

(ii) The Y Corporation assumes an indebtedness of $100,000 owed by the X Corporation to another company, the A Corporation; or

(iii) The Y Corporation takes over the property conveyed to it by the X Corporation subject to a mortgage of $100,000.

(2) Short-term obligations (including notes, drafts, bills of exchange, and bankers' acceptances) having a maturity at the time of issuance of not exceeding 24 months, exclusive of days of grace.

(3) Securities issued or guaranteed as to principal or interest by a government or subdivision thereof (including those issued by a corporation which is an instrumentality of a government or subdivision thereof).

(4) Stock or securities which were acquired from a registered holding company which acquired such stock or securities after February 28, 1938, or an associate company of a registered holding

company which acquired such stock or securities after February 28, 1938, unless such stock or securities were acquired in obedience to an order of the Securities and Exchange Commission (as defined in section 1083(a)) or were acquired with the authorization or approval of the Securities and Exchange Commission under any section of the Public Utility Holding Company Act of 1935, and are not nonexempt property within the meaning of section 1083(e) (1), (2), or (3).

(5) Money, and the right to receive money not evidenced by a security other than an obligation described as nonexempt property in section 1083(e)(2) or (3). The term "the right to receive money" includes, among other items, accounts receivable, claims for damages, and rights to refunds of taxes.

(f) *Stock or securities*.—The term "stock or securities" is defined in section 1083(f) for the purposes of sections 1081 to 1083, inclusive. As therein defined, the term includes voting trust certificates and stock rights or warrants.

WASH SALES OF STOCKS OR SECURITIES

§ 1.1091 STATUTORY PROVISIONS; LOSSES FROM WASH SALES OF STOCKS OR SECURITIES; BASIS.

SEC. 1091. LOSS FROM WASH SALES OF STOCK OR SECURITIES.

(a) DISALLOWANCE OF LOSS DEDUCTION.—In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction for the loss shall be allowed under section 165(c)(2); nor shall such deduction be allowed a corporation under section 165(a) unless it is a dealer in stocks or securities, and the loss is sustained in a transaction made in the ordinary course of its business.

(b) STOCK ACQUIRED LESS THAN STOCK SOLD.—If the amount of stock or securities acquired (or covered by the contract or option to acquire) is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be determined under regulations prescribed by the Secretary or his delegate.

(c) STOCK ACQUIRED NOT LESS THAN STOCK SOLD.—If the amount of stock or securities acquired (or covered by the contract or option to acquire) is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility of the loss shall be determined under regulations prescribed by the Secretary or his delegate.

(d) UNADJUSTED BASIS IN CASE OF WASH SALE OF STOCK.—If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

§ 1.1091–1 LOSSES FROM WASH SALES OF STOCK OR SECURITIES.—(a) A taxpayer cannot deduct any loss claimed to have been sustained

from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date (referred to in this section as the 61-day period), he has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities. However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business, or (2) in the case of a corporation, a dealer in stock or securities, if the sale or other disposition of stock or securities is made in the ordinary course of its business as such dealer.

(b) Where more than one loss is claimed to have been sustained within the taxable year from the sale or other disposition of stock or securities, the provisions of this section shall be applied to the losses in the order in which the stock or securities the disposition of which resulted in the respective losses were disposed of (beginning with the earliest disposition). If the order of disposition of stock or securities disposed of at a loss on the same day cannot be determined, the stock or securities will be considered to have been disposed of in the order in which they were orginally acquired (beginning with the earliest acquisition).

(c) Where the amount of stock or securities acquired within the 61-day period is less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the loss from the sale or other disposition of which is not deductible shall be those with which the stock or securities acquired are matched in accordance with the following rule: The stock or securities acquired will be matched in accordance with the order of their acquisition (beginning with the earliest acquisition) with an equal number of the shares of stock or securities sold or otherwise disposed of.

(d) Where the amount of stock or securities acquired within the 61-day period is not less than the amount of stock or securities sold or otherwise disposed of, then the particular shares of stock or securities the acquisition of which resulted in the nondeductibility of the loss shall be those with which the stock or securities disposed of are matched in accordance with the following rule: The stock or securities sold or otherwise disposed of will be matched with an equal number of the shares of stock or securities acquired in accordance with the order of acquisition (beginning with the earliest acquisition) of the stock or securities acquired.

(e) The acquisition of any share of stock or any security which results in the nondeductibility of a loss under the provisions of this section shall be disregarded in determining the deductibility of any other loss.

(f) The word "acquired" as used in this section means acquired by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law, and comprehends cases where the taxpayer has entered into a contract or option within the 61-day period to acquire by purchase or by such an exchange.

(g) The following examples illustrate the application of this section:

Example (1). A, whose taxable year is the calendar year, on December 1, 1954, purchased 100 shares of common stock in the M Company for $10,000 and on December 15, 1954, purchased 100 additional shares for $9,000. On January 3, 1955, he sold the 100 shares purchased on December 1, 1954, for $9,000. Because of the provisions of section 1091, no loss from the sale is allowable as a deduction.

Example (2). A, whose taxable year is the calendar year, on September 21, 1954, purchased 100 shares of the common stock of the M Company for $5,000. On December 21, 1954, he purchased 50 shares of substantially identical stock for $2,750, and on December 27, 1954, he purchased 25 additional shares of such stock for $1,125. On January 3, 1955, he sold for $4,000 the 100 shares purchased on September 21, 1954. There is an indicated loss of $1,000 on the sale of the 100 shares. Since, within the 61-day period, A purchased 75 shares of substantially identical stock, the loss on the sale of 75 of the shares ($3,750−$3,000, or $750) is not allowable as a deduction because of the provisions of section 1091. The loss on the sale of the remaining 25 shares ($1,250−$1,000, or $250) is deductible subject to the limitations provided in sections 267 and 1211. The basis of the 50 shares purchased December 21, 1954, the acquisition of which resulted in the nondeductibility of the loss ($500) sustained on 50 of the 100 shares sold on January 3, 1955, is $2,500 (the cost of 50 of the shares sold on January 3, 1955) +$750 (the difference between the purchase price ($2,750) of the 50 shares acquired on December 21, 1954, and the selling price ($2,000) of 50 of the shares sold on January 3, 1955), or $3,250. Similarly, the basis of the 25 shares purchased on December 27, 1954, the acquisition of which resulted in the nondeductibility of the loss ($250) sustained on 25 of the shares sold on January 3, 1955, is $1,250+$125, or $1,375. See § 1.1091–2.

Example (3). A, whose taxable year is the calendar year, on September 15, 1954, purchased 100 shares of the stock of the M Company for $5,000. He sold these shares on February 1, 1956, for $4,000. On each of the four days from February 15, 1956, to February 18, 1956, inclusive, he purchased 50 shares of substantially identical stock for $2,000. There is an indicated loss of $1,000 from the sale of the 100 shares on February 1, 1956, but, since within the 61-day period A purchased not less than 100 shares of substantially identical stock, the loss is not deductible. The particular shares of stock the purchase of which resulted in the nondeductibility of the loss are the first 100 shares purchased within such period, that is, the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956. In determining the period for which the 50 shares purchased on February 15, 1956, and the 50 shares purchased on February 16, 1956, were held, there is to be included the period for which the 100 shares purchased on September 15, 1954, and sold on February 1, 1956, were held.

§ 1.1091–2 BASIS OF STOCKS OR SECURITIES ACQUIRED IN "WASH SALES."—The application of section 1091(d) may be illustrated by the following examples:

Example (1). A purchased a share of common stock of the X Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $90. No loss from the sale is recognized under section 1091. The basis of the new share is $110; that is, the basis of the old share ($100) increased by $10, the excess of the price at which the new share was acquired ($90) over the price at which the old share was sold ($80).

Example (2). A purchased a share of common stock of the Y Corporation for $100 in 1935, which he sold January 15, 1955, for $80. On February 1, 1955, he purchased a share of common stock of the same corporation for $70. No loss from the sale is recognized under section 1091. The basis of the new share is $90; that is, the basis of the old share ($100) decreased by $10, the excess of the price at which the old share was sold ($80) over the price at which the new share was acquired ($70).

CAPITAL GAINS AND LOSSES

SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

§ 1.1233 STATUTORY PROVISIONS; GAINS AND LOSSES FROM SHORT SALES.

SEC. 1233. GAINS AND LOSSES FROM SHORT SALES.

(a) CAPITAL ASSETS.—For purposes of this subtitle, gain or loss from the short sale of property, other than a hedging transaction in commodity futures, shall be considered as gain or loss from the sale or exchange of a capital asset to the extent that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of the taxpayer.

(b) SHORT-TERM GAINS AND HOLDING PERIODS.—If gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months (determined without regard to the effect, under paragraph (2) of this subsection, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof—

(1) any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 6 months (notwithstanding the period of time any property used to close such short sale has been held); and

(2) the holding period of such substantially identical property shall be considered to begin (notwithstanding section 1223, relating to the holding period of property) on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of such property, whichever date occurs first. This paragraph shall apply to such substantially identical property in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short.

For purposes of this subsection, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale.

(c) CERTAIN OPTIONS TO SELL.—Subsection (b) shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so

identified. If the option is not exercised, the cost of the option shall be added to the basis of the property with which the option is identified. This subsection shall apply only to options acquired after the date of enactment of this title.

(d) LONG-TERM LOSSES.—If on the date of such short sale substantially identical property has been held by the taxpayer for more than 6 months, any loss on the closing of such short sale shall be considered as a loss on the sale or exchange of a capital asset held for more than 6 months (notwithstanding the period of time any property used to close such short sale has been held, and notwithstanding section 1234).

(e) RULES FOR APPLICATION OF SECTION—

(1) Subsection (b)(1) or (d) shall not apply to the gain or loss, respectively, on any quantity of property used to close such short sale which is in excess of the quantity of the substantially identical property referred to in the applicable subsection.

(2) For purposes of subsections (b) and (d)—

(A) the term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer;

(B) in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in 1 calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month; and

(C) in the case of a short sale of property by an individual, the term "taxpayer", in the application of this subsection and subsections (b) and (d), shall be read as "taxpayer or his spouse"; but an individual who is legally separated from the taxpayer under a decree of divorce or of separate maintenance shall not be considered as the spouse of the taxpayer.

(3) Where the taxpayer enters into 2 commodity futures transactions on the same day, one requiring delivery by him in one market and the other requiring delivery to him of the same (or substantially identical) commodity in the same calendar month in a different market, and the taxpayer subsequently closes both such transactions on the same day, subsections (b) and (d) shall have no application to so much of the commodity involved in either such transaction as does not exceed in quantity the commodity involved in the other.

(f) ARBITRAGE OPERATIONS IN SECURITIES.—In the case of a short sale which had been entered into as an arbitrage operation, to which sale the rule of subsection (b)(2) would apply except as otherwise provided in this subsection—

(1) subsection (b)(2) shall apply first to substantially identical assets acquired for arbitrage operations held at the close of business on the day such sale is made, and only to the extent that the quantity sold short exceeds the substantially identical assets acquired for arbitrage operations held at the close of business on the day such sale is made, shall the holding period of any other such identical assets held by the taxpayer be affected;

(2) in the event that assets acquired for arbitrage operations are disposed of in such manner as to create a net short position in assets acquired for arbitrage operations, such net short position shall be deemed to constitute a short sale made on that day;

(3) for the purpose of paragraphs (1) and (2) of this subsection the taxpayer will be deemed as of the close of any business day to hold property which he is or will be entitled to receive or acquire by virtue of any other asset acquired for arbitrage operations or by virtue of any contract he has entered into in an arbitrage operation; and

(4) for the purpose of this subsection arbitrage operations are transactions involving the purchase and sale of assets for the purpose of profiting from a current difference between the price of the asset purchased and the price of the asset sold, and in which the asset purchased, if not identical to the asset sold, is such that by virtue thereof the taxpayer is, or will be, entitled to acquire assets identical to the assets sold.

§ 1.1233

Such operations must be clearly identified by the taxpayer in his records as arbitrage operations on the day of the transaction or as soon thereafter as may be practicable. Assets acquired for arbitrage operations will include stocks and securities and the right to acquire stocks and securities.

[Sec. 1233(f), I. R. C. 1954, as added by sec. 1, Pub. Law 385, 84th Cong. Under sec. 2, Pub. Law 385, 84th Cong.. the amendment made by sec. 1 of such Act shall apply only with respect to taxable years ending after August 12, 1955, the date of the enactment of such Act, and only in the case of a short sale of property made by the taxpayer after such date.]

§ 1.1233–1 Gains and Losses From Short Sales.—(a) *General.*—(1) For income tax purposes a short sale is not deemed to be consummated until delivery of property to close the short sale. Whether the recognized gain or loss from a short sale is capital gain or loss or ordinary gain or loss depends upon whether the property so delivered constitutes a capital asset in the hands of the taxpayer.

(2) Thus, if a dealer in securities makes a short sale of X Corporation stock, ordinary gain or loss results on closing of the short sale if the stock used to close the short sale was stock which he held primarily for sale to customers in the ordinary course of his trade or business. If the stock used to close the short sale was a capital asset in his hands, or if the taxpayer in this example was not a dealer, a capital gain or loss would result.

(3) Generally, the period for which a taxpayer holds property delivered to close a short sale determines whether long-term or short-term capital gain or loss results.

(4) Thus, if a taxpayer makes a short sale of shares of stock and covers the short sale by purchasing and delivering shares which he held for not more than six months, the recognized gain or loss would be considered short-term capital gain or loss. If the short sale is made through a broker and the broker borrows property to make a delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

(b) *Hedging transactions.*—Gain or loss from a bona fide hedging transaction in commodity futures entered into by flour millers, producers of cloth, operators of grain elevators, etc., for the purpose of their business shall not be considered gain or loss from the sale or exchange of a capital asset. Gain or loss from a short sale of commodity futures which does not qualify as a hedging transaction shall be considered gain or loss from the sale or exchange of a capital asset if the commodity future used to close the short sale constitutes a capital asset in the hands of the taxpayer as explained in paragraph (a) of this section.

(c) *Special short sales.*—(1) *General.*—Section 1233 provides rules as to the tax consequences of a short sale of property if gain or loss from the short sale is considered as gain or loss from the sale or exchange of a capital asset under section 1233(a) and paragraph (a) of this section and if, at the time of the short sale or on or before the date of the closing of the short sale, the taxpayer holds property substantially identical to that sold short. The term "property" is defined for purposes of such rules to include only stocks and securities

(including stocks and securities dealt with on a "when issued" basis) and commodity futures, which are capital assets in the hands of the taxpayer. Certain restrictions on the application of the section to commodity futures are provided in section 1233(e) and paragraph (d)(2) of this section. Section 1233(f) contains special provisions governing the operation of rule (2) in subparagraph (2) of this paragraph in the case of a purchase and short sale of stocks or securities in a transaction qualifying as an arbitrage operation.

(2) *Treatment of special short sales.*—The first two rules, which are set forth in section 1233(b), are applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than six months (determined without regard to rule (2), below, relating to the holding period) or is acquired by him after the short sale and on or before the date of the closing thereof. These rules are:

Rule (1). Any gain upon the closing of such short sale shall be considered as a gain upon the sale or exchange of a capital asset held for not more than six months (notwithstanding the period of time any property used to close such short sale has been held); and

Rule (2). The holding period of such substantially identical property shall be considered to begin (notwithstanding the provisions of section 1233) on the date of the closing of such short sale or on the date of a sale, gift, or other disposition of such property, whichever date occurs first.

(3) *Options to sell.*—For the purpose of rule (1) and rule (2) in subparagraph (2) of this paragraph, the acquisition of an option to sell property at a fixed price shall be considered a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale, except that any option to sell property at a fixed price acquired on or after August 17, 1954 (the day after enactment of the Internal Revenue Code of 1954), shall not be considered a short sale and the exercise or failure to exercise such option shall not be considered as the closing of a short sale provided that the option and property identified as intended to be used in its exercise are acquired on the same date. This exception shall not apply, if the option is exercised, unless it is exercised by the sale of the property so identified. In the case of any option not exercised which falls within this exception, the cost of such option shall be added to the basis of the property with which such option is identified. If the option itself does not specifically identify the property intended to be used in exercising the option, then the identification of such property shall be made by appropriate entries in the taxpayer's records within 15 days after the date such property is acquired or within 30 days after the promulgation of regulations under section 1233, whichever expiration date later occurs.

(4) *Treatment of losses.*—The third rule, which is set forth in section 1233(d), is applicable whenever property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than six months. This rule is:

Rule (3). Any loss upon the closing of such short sale shall be considered as a loss upon the sale or exchange of a capital asset held

for more than six months, notwithstanding the period of time any property used to close such short sale has been held. For the purpose of rule (3), the acquisition of an option to sell property at a fixed price is not considered a short sale, and the exercise or failure to exercise such option is not considered as a closing of a short sale.

(5) *Application of rules.*—Rules (1) and (3) do not apply to the gain or loss attributable to so much of the property sold short as exceeds in quantity the substantially identical property referred to in sections 1233(b) and 1233(d), respectively. Except as otherwise provided in section 1233(f), rule (2) applies to the substantially identical property referred to in section 1233(b) in the order of the dates of the acquisition of such property, but only to so much of such property as does not exceed the quantity sold short. If property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for not more than six months, or is acquired by him after the short sale and on or before the date of the closing thereof, and if property substantially identical to that sold short has been held by the taxpayer on the date of the short sale for more than six months, all three rules are applicable.

(6) *Examples.* The following examples illustrate the application of these rules to short sales of stock in the case of a taxpayer who makes his return on the basis of the calendar year:

Example (1). A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, and closes the short sale on August 2, 1955, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than six months, the gain of $600 realized upon the closing of the short sale is, by application of rule (1), a short-term capital gain.

Example (2). A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on July 1, 1955, closes the short sale on August 1, 1955, with 100 shares of X stock purchased on that date at $18 per share, and on August 2, 1955, sells at $18 per share the 100 shares of X stock purchased on February 1, 1955. The $200 loss sustained upon the closing of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2), however, the holding period of the 100 shares of X stock purchased on February 1, 1955, and sold on August 2, 1955, is considered to begin on August 1, 1955, the date of the closing of the short sale. The $800 gain realized upon the sale of such stock is, therefore, a short-term capital gain.

Example (3). A buys 100 shares of X stock at $10 per share on February 1, 1955, sells short 100 shares of X stock at $16 per share on September 1, 1955, sells on October 1, 1955, at $18 per share the 100 shares of X stock purchased on February 1, 1955, and closes the short sale on October 1, 1955, with 100 shares of X stock purchased on that date at $18 per share. The $800 gain realized upon the sale

of the 100 shares of X stock purchased on February 1, 1955, is a long-term capital gain to which section 1233(b) has no application. Since A had held 100 shares of X stock on the date of the short sale for more than six months, the $200 loss sustained upon the closing of the short sale is, by application of rule (3), a long-term capital loss. If, instead of purchasing 100 shares of X stock on October 1, 1955, A closed the short sale with the 100 shares of stock purchased on February 1, 1955, the $600 gain realized on the closing of the short sale would be a long-term capital gain to which section 1233 (b) has no application.

Example (4). A sells short 100 shares of X stock at $16 per share on February 1, 1955. He buys 250 shares of X stock on March 1, 1955, at $10 per share and holds the latter stock until September 2, 1955 (more than six months), at which time, 100 shares of the 250 shares of X stock are delivered to close the short sale made on February 1, 1955. Since substantially identical property was acquired by A after the short sale and before it was closed, the $600 gain realized on the closing of the short sale is, by application of rule (1), a short-term capital gain. The holding period of the remaining 150 shares of X stock is not affected by section 1233 since this amount of the substantially identical property exceeds the quantity of the property sold short.

Example (5). A buys 100 shares of X stock at $10 per share on February 1, 1955, buys an additional 100 shares of X stock at $20 per share on July 1, 1955, sells short 100 shares of X stock at $30 per share on September 1, 1955, and closes the short sale on February 1, 1956, by delivering the 100 shares of X stock purchased on February 1, 1955, to the lender of the stock used to effect the short sale. Since 100 shares of X stock had been held by A on the date of the short sale for not more than six months, the gain of $2,000 realized upon the closing of the short sale is, by application of rule (1), a short-term capital gain and the holding period of the 100 shares of X stock purchased on July 1, 1955, is considered, by application of rule (2), to begin on February 1, 1956, the date of the closing of the short sale. If, however, the 100 shares of X stock purchased on July 1, 1955, had been used by A to close the short sale, then, since 100 shares of X stock had been held by A on the date of the short sale for not more than six months, the gain of $1,000 realized upon the closing of the short sale would be, by application of rule (1), a short-term capital gain, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233. If, on the other hand, A purchased an additional 100 shares of X stock at $40 per share on February 1, 1956, and used such shares to close the short sale at that time, then, since 100 shares of X stock had been held by A on the date of the short sale for more than six months, the loss of $1,000 sustained upon the closing of the short sale would be, by application of rule (3), a long-term capital loss, and since 100 shares of X stock had been held by A on the date of the short sale for not more than six months, the holding period of the 100 shares of X stock purchased on July 1, 1955, would be considered, by application of rule (2), to begin

on February 1, 1956, but the holding period of the 100 shares of X stock purchased on February 1, 1955, would not be affected by section 1233.

Example (6). A buys 100 shares of X preferred stock at $10 per share on February 1, 1955. On July 1, 1955, he enters into a contract to sell 100 shares of XY common stock at $16 per share when, as, and if issued pursuant to a particular plan of reorganization. On August 2, 1955, he receives 100 shares of XY common stock in exchange for the 100 shares of X preferred stock purchased on February 1, 1955, and delivers such common shares in performance of his July 1, 1955, contract. Assume that the exchange of the X preferred stock for the XY common stock is a tax-free exchange pursuant to section 354(a)(1), and that on the basis of all of the facts and circumstances existing on July 1, 1955, the "when issued" XY common stock is substantially identical to the X preferred stock. Since 100 shares of substantially identical property had been held by A for not more than six months on the date of entering into the July 1, 1955, contract of sale, the gain of $600 realized upon the closing of the contract of sale is, by application of rule (1), a short-term capital gain.

(d) *Other rules for the application of section 1233.*—(1) *Substantially identical property.*—The term "substantially identical property" is to be applied according to the facts and circumstances in each case. In general, as applied to stocks or securities, the term has the same meaning as the term "substantially identical stock or securities" used in section 1091, relating to wash sales of stocks or securities. For certain restrictions on the term as applied to commodity futures see subparagraph (2) of this paragraph. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property. Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. Similarly, depending on the facts and circumstances, the term may apply to the stocks and securities to be received in a corporate reorganization or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization.

(2) *Commodity futures.*—(i) As provided in section 1233(e)(2)(B), in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month. For example, commodity futures in May wheat and July wheat are not considered,

for the purpose of section 1233, substantially identical property. Simi larly, futures in different commodities which are not generally throug custom of the trade used as hedges for each other (such as corn an wheat, for example) are not considered substantially identical prop erty. If commodity futures are otherwise substantially identical prop erty, the mere fact that they were procured through different broker will not remove them from the scope of the term "substantially iden tical property." Commodity futures procured on different market may come within the term "substantially identical property" depend ing upon the facts and circumstances in the case, with the historica similarity in the price movements in the two markets as the primar factor to be considered.

(ii) Section 1233(e)(3), relating to so-called "arbitrage" transac tions in commodity futures, provides that where a taxpayer enters int two commodity futures transactions on the same day, one requirin delivery by him in one market and the other requiring delivery t him of the same (or substantially identical) commodity in the sam calendar month in a different market, and the taxpayer subsequentl closes both such transactions on the same day, section 1233 shall hav no application to so much of the commodity involved in either suc transaction as does not exceed in quantity the commodity involve in the other. Section 1233(f), relating to arbitrage operations i stocks or securities, has no application to arbitrage transactions i commodity futures.

(iii) The following example indicates the application of sectio 1233 to a commodity futures transaction:

Example. A, who makes his return on the basis of the calenda year, on February 1, 1955, enters into a contract through broker X to purchase 10,000 bushels of December wheat on the Chicago marke at $2 per bushel. On July 1, 1955, he enters into a contract throug broker Y to sell 10,000 bushels of December wheat on the Chicag market at $2.25 per bushel. On August 2, 1955, he closes both trans actions at $2.50 per bushel. The $2,500 loss sustained on the closin of the short sale is a short-term capital loss to which section 1233(d) has no application. By application of rule (2) in paragraph (c) o this section, however, the holding period of the futures contract en tered into on February 1, 1955, is considered to begin on August 2 1955, the date of the closing of the short sale. The $5,000 gain real ized upon the closing of such contract is, therefore, a short-term capital gain.

(3) *Husband and wife.*—Section 1233(e)(2)(C) provides that, in the case of a short sale of property by an individual, the term "tax payer" in the application of subsections (b), (d), and (e) shall be read as "taxpayer or his spouse." Thus, if the spouse of a taxpayer holds or acquires property substantially identical to that sold short by the taxpayer, and other conditions of subsections (b), (d), and (e) are met, then the rules set forth therein are applicable to the same extent as if the taxpayer held or acquired the substantially identical property. For this purpose, an individual who is legally separated from the taxpayer under a decree of divorce or of separate mainte nance shall not be considered as the spouse of the taxpayer.

TAX ON SELF-EMPLOYMENT INCOME

§ 1.1401 Statutory Provisions; Rate of Tax on Self-Employment Income.

SEC. 1401. RATE OF TAX.

In addition to other taxes, there shall be imposed for each taxable year, on the self-employment income of every individual, a tax as follows:

(1) in the case of any taxable year beginning before January 1, 1960, the tax shall be equal to 3 percent of the amount of the self-employment income for such taxable year;

(2) in the case of any taxable year beginning after December 31, 1959, and before January 1, 1965, the tax shall be equal to 3¾ percent of the amount of the self-employment income for such taxable year;

(3) in the case of any taxable year beginning after December 31, 1964, and before January 1, 1970, the tax shall be equal to 4½ percent of the amount of the self-employment income for such taxable year;

(4) in the case of any taxable year beginning after December 31, 1969, and before January 1, 1975, the tax shall be equal to 5¼ percent of the amount of the self-employment income for such taxable year;

(5) in the case of any taxable year beginning after December 31, 1974, the tax shall be equal to 6 percent of the amount of the self-employment income for such taxable year.

[Sec. 1401 as amended by sec. 208(a), Social Security Amendments of 1954.]

§ 1.1401–1 Tax on Self-Employment Income.—(a) There is imposed, in addition to other taxes, a tax upon the self-employment income of every individual at the rates prescribed in section 1401. This tax shall be levied, assessed, and collected as part of the income tax imposed by subtitle A of the Internal Revenue Code and, except as otherwise expressly provided, will be included with the tax imposed by section 1 or 3 in computing any deficiency or overpayment and in computing the interest and additions to any deficiency, overpayment, or tax. Since the tax on self-employment income is part of the income tax, it is subject to the jurisdiction of the Tax Court of the United States to the same extent and in the same manner as the other taxes under subtitle A of the Internal Revenue Code. However, this tax is not required to be taken into account in computing any estimate of the taxes required to be declared under section 6015.

(b) In general, self-employment income consists of the net earnings derived by an individual (other than a nonresident alien) from a trade or business carried on by him as sole proprietor or by a partnership of which he is a member, including the net earnings of certain employee newsboys and certain employee ministers and members of religious orders. See, however, the exclusions, exceptions, and limitations set forth in §§ 1.1402(a)–1 through 1.1402(e)–1.

§ 1.1402(a) Statutory Provisions; Definitions; Net Earnings From Self-Employment.

SEC. 1402. DEFINITIONS.

(a) Net Earnings From Self-Employment.—The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(9) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and

deductions and such distributive share of partnership ordinary income or loss—

(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer;

(2) there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest (other than interest described in section 35) are received in the course of a trade or business as a dealer in stocks or securities;

(3) there shall be excluded any gain or loss—

(A) which is considered as gain or loss from the sale or exchange of a capital asset,

(B) from the cutting of timber, or the disposal of timber or coal, if section 631 applies to such gain or loss, or

(C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither—

(i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii) property held primarily for sale to customers in the ordinary course of the trade or business;

(4) the deduction for net operating losses provided in section 172 shall not be allowed;

(5) if—

(A) any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife; and

(B) any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(6) a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933;

(7) the deduction for personal exemptions provided in section 151 shall not be allowed;

(8) an individual who is—

(A) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order; and

(B) a citizen of the United States performing service described in subsection (c)(4) as an employee of an American employer (as defined in section 3121(h))

shall compute his net earnings from self-employment derived from the performance of service described in subsection (c)(4) without regard to section 911 (relating to earned income from sources without the United States) and section 931 (relating to income from sources within possessions of the United States).

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary

income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year. In the case of any trade or business which is carried on by an individual who reports his income on a cash receipts and disbursements basis, and in which, if it were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g), (i) if the gross income derivered from such trade or business by such individual is not more than $1,800, the net earnings from self-employment derived by him therefrom may, at his option, be deemed to be 50 percent of such gross income in lieu of his net nearnings from self-employment from such trade or business computed as provided under the preceding provisions of this subsection, or (ii) if the gross income derived from such trade or business by such individual is more than $1,800 and the net earnings from self-employment derived by him therefrom, as computed under the preceding provisions of this subsection, are less than $900, such net earnings may instead, at the option of such individual, be deemed to be $900. For the purpose of the preceding sentence, gross income derived from such trade or business shall mean the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the preceding provisions of this subsection.

[SEC. 1402(a) as amended by sec. 201(a) and (c)(4), Social Security Amendments of 1954, for taxable years ending after 1954. For taxable years ending before 1955, sec. 1402(a), as set forth below, is applicable.

SEC. 1402. DEFINITIONS.

(a) NET EARNINGS FROM SELF-EMPLOYMENT.—The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this substitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(9) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

(1) there shall be excluded rentals from real estate (including personal property leased with the real estate) and deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer;

(2) there shall be excluded income derived from any trade or business in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g); and there shall be excluded all deductions attributable to such income;

(3) there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest (other than interest described in section 35) are received in the course of a trade or business as a dealer in stocks or securities;

(4) there shall be excluded any gain or loss—

(A) which is considered as gain or loss from the sale or exchange of a capital asset,

(B) from the cutting of timber, or the disposal of timber or coal, if section 631 applies to such gain or loss, or

(C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither—

(i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii) property held primarily for sale to customers in the ordinary course of the trade or business;

(5) the deduction for net operating losses provided in section 172 shall not be allowed;

(6) if—

(A) any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife; and

(B) any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

(7) a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933;

(8) the deduction for personal exemptions provided in section 151 shall not be allowed.

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year.]

§ 1.1402(a)-1 NET EARNINGS FROM SELF-EMPLOYMENT—(a) *Definition.*—(1) Subject to the special rules set forth in paragraph (c) of this section and to the exclusions set forth in § 1.1402(c)-1, the term "net earnings from self-employment" means—

(i) The gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by chapter 1 of the Internal Revenue Code which are attributable to such trade or business, plus

(ii) His distributive share (whether or not distributed), as determined under section 704, of the income (or minus the loss), described in section 702(a)(9) and as computed under section 703 from any trade or business carried on by any partnership of which he is a member.

(2) Gross income derived by an individual from a trade or business includes payments received by him from a partnership of which he is a member for services rendered to the partnership or for the use of capital by the partnership, to the extent the payments are determined without regard to the income of the partnership. However, such payments received from a partnership not engaged in a trade or business within the meaning of section 1402(c) and § 1.1402(c)-1 do not constitute gross income derived by an individual from a trade or business. See section 707(c) and the regulations thereunder, relating to guaranteed payments to a member of a partnership for services or the use of capital. See also section 706(a) and the regulations thereunder, relating to the taxable year of the partner in which such guaranteed payments are to be included in computing taxable income.

(3) Gross income derived by an individual from a trade or business includes gross income received (in the case of an individual reporting income on the cash receipts and disbursements method) or accrued (in the case of an individual reporting income on the accrual method) in the taxable year from a trade or business even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year as to which the individual was not subject to the tax on self-employment income.

(b) *Computation of net earnings*—(1) *General rule.*—In general, the gross income and deductions of an individual attributable to a trade or business (including a trade or business conducted by an employee referred to in paragraph (c)(1) or (2) of § 1.1402(c)-1), for the purpose of ascertaining his net earnings from self-employment, are to be determined by reference to the provisions of law and regulations applicable with respect to the taxes imposed by sections 1 and 3. Thus, if an individual uses the accrual method of accounting in computing taxable income from a trade or business for the purpose of the tax imposed by section 1 or 3, he must use the same method in determining net earnings from self-employment. Likewise, if a taxpayer engaged in a trade or business of selling property on the installment plan elects, under the provisions of section 453, to use the installment method in computing income for purposes of the tax under section 1 or 3, he must use the same method in determining net earnings from self-employment. Except as otherwise provided in paragraph (c)(6) of this section, relating to certain residents of Puerto Rico, and in paragraph (c)(8) of this section, relating to ministers or members of religious orders, income which is excludable from gross income under any provision of subtitle A of the Internal Revenue Code is not taken into account in determining net earnings from self-employment. Thus, in the case of a citizen of the United States conducting, in a foreign country, a trade or business in which both personal services and capital are material income-producing factors, any part of the income therefrom which is excluded from gross income as earned income under the provisions of section 911 and the regulations thereunder is not taken into account in determining net earnings from self-employment.

(2) *Trade or business carried on.*—The trade or business must be carried on by the individual, either personally on through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.

(3) *Aggregate net earnings.*—Where an individual is engaged in more than one trade or business within the meaning of section 1402(c) and § 1.1402(c)-1, his net earnings from self-employment consist of the aggregate of the net income and losses (computed subject to the special rules provided in this section) of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business.

(4) *Partnerships.*—The net earnings from self-employment of an

individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the income or loss, described in section 702(a) (9), from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704, subject to the special rules set forth in section 1402(a) and in this section and to the exclusions provided in section 1402(c) and in § 1.1402(c)-1. For provisions relating to the computation of the taxable income of a partnership, see section 703.

(5) *Different taxable years.*—If the taxable year of a partner differs from that of the partnership, the partner shall include, in computing net earnings from self-employment, his distributive share of the income or loss, described in section 702(a) (9), of the partnership for its taxable year ending with or within the taxable year of the partner.

(6) *Meaning of partnerships.*—For the purpose of determining net earnings from self-employment, a partnership is one which is recognized as such for income tax purposes. For income tax purposes, the term "partnership" includes not only a partnership as known at common law, but, also, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any trade or business, financial operation, or venture, and which is not, within the meaning of the Internal Revenue Code, a trust, estate, or a corporation. An organization described in the preceding sentence shall be treated as a partnership for purposes of the tax on self-employment income even though such organization has elected, pursuant to section 1361 and the regulations thereunder, to be taxed as a domestic corporation.

(7) *Nature of partnership interest.*—The net earnings from self-employment of a partner include his distributive share of the income or loss, described in section 702(a) (9), of the partnership of which he is a member, irrespective of the nature of his membership. Thus, in determining his net earnings from self-employment, a limited or inactive partner includes his distributive share of such partnership income or loss. In the case of a partner who is a member of a partnership with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702(a) (9), from the trade or business carried on by the partnership computed without regard to the fact that the partnership has elected to be taxed as a domestic corporation.

(8) *Proprietorship taxed as domestic corporation.*—A proprietor of an unincorporated business enterprise with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation shall compute his net earnings from self-employment without regard to the fact that such election has been made.

(c) *Special rules for computing net earnings.*—For the purpose of computing net earnings from self-employment, the gross income derived by an individual from a trade or business carried on by him,

the allowable deductions attributable to such trade or business, and the individual's distributive share of the income or loss, described in section 702(a)(9), from any trade or business carried on by a partnership of which he is a member shall be computed in accordance with the following special rules:

(1) *Rentals from real estate.*—(i) Rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) and the deductions attributable thereto, unless such rentals are received by an individual in the course of a trade or business as a real-estate dealer, are excluded. Whether or not an individual is engaged in the trade or business of a real-estate dealer is determined by the application of the principles followed in respect of the taxes imposed by sections 1 and 3. In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded. Rentals paid in crop shares include income derived by an individual as the owner or lessee of land under an agreement entered into with another person pursuant to which such other person undertakes to produce a crop or livestock on such land and pursuant to which (*a*) the crop or livestock, or the proceeds thereof, are to be divided between such individual and such other person, and (*b*) the amount of such individual's share depends on the amount of the crop or livestock produced.

(ii) Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate. Except in the case of real-estate dealers, such payments are excluded in determining net earnings from self-employment even though such payments are in part attributable to personal property furnished under the lease.

(iii) Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate; consequently, such payments are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for accupancy only. The supplying of maid service, for example, constitutes such service;

whereas, the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.

(iv) Except in the case of a real-estate dealer, where an individual or a partnership is engaged in a trade or business the income of which is classifiable in part as rentals from real estate, only that portion of such income which is not classifiable as rentals from real estate, and the expenses attributable to such portion, are included in determining net earnings from self-employment.

(v) The application of this subparagraph may be illustrated by the following example:

Example.—A, an individual, owns a building containing four apartments. During the taxable year, he receives $1,400 from apartments numbered 1 and 2, which are rented without services rendered to the occupants, and $3,600 from apartments numbered 3 and 4, which are rented with services rendered to the occupants. His fixed expenses for the four apartments aggregate $1,200 during the taxable year. In addition, he has $500 of expenses attributable to the services rendered to the occupants of apartments 3 and 4. In determining his net earnings from self-employment, A includes the $3,600 received from apartments 3 and 4, and the expenses of $1,100 ($500 plus ½ of $1,200) attributable thereto. The rentals and expenses attributable to apartments 1 and 2 are excluded. Therefore, A has $2,500 of net earnings from self-employment for the taxable year from the building.

(2) *Dividends and interest.*—(i) All dividends on shares of stock are excluded unless they are received by an individual in the course of his trade or business as a dealer in stocks or securties.

(ii) Interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), is excluded unless such interest is received in the course of a trade or business as a dealer in stocks or securities. However, interest with respect to which a credit against tax is allowable as provided in section 35, that is, interest on certain obligations of the United States and its instrumentalities, is not included in net earnings from self-employment even though received in the course of a trade or business as a dealer in stocks or securities. Only interest on bonds, debentures, notes, or certificates, or other evidence of indebtedness, issued with interest coupons or in registered form by a corporation, is excluded in the case of all persons other than dealers in stocks or securities; other interest received in the course of any trade or business (such as interest received by a pawnbroker on his loans or interest received by a merchant on his accounts or notes receivable) is not excluded.

(iii) Dividends and interest of the character excludable under the preceding subdivisions of this subparagraph received by an individual on stocks or securities held for speculation or investment are excluded whether or not the individual is a dealer in stocks or securities.

(iv) A dealer in stocks or securities is a merchant of stocks or securities with an established place of business, regularly engaged in

the business of purchasing stocks or securities and reselling them to cutomers; that is, he is one who as a merchant buys stocks or securities and sells them to customers with a view to the gains and profits that may be derived therefrom. Persons who buy and sell or hold stocks or securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, are not dealers in stocks or securities.

(3) *Gain or loss from disposition of property.*—(i) There is excluded any gain or loss: (*a*) Which is considered as gain or loss from the sale or exchange of a captial asset; (*b*) from the cutting of timber or the disposal of timber or the disposal of coal, even though held primarily for sale to customers, if section 631 is applicable to such gain or loss; and (*c*) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither (*1*) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor (*2*) property held primarily for sale to customers in the ordinary course of a trade or business. For the purpose of the special rule in (*c*) of this subdivision, it is immaterial whether a gain or loss is treated as a capital gain or loss or as an ordinary gain or loss for purposes other than determining net earnings from self-employment. For instance, where the character of a loss is governed by the provisions of section 1231, such loss is excluded in determining net earnings from self-employment even though such loss is treated under section 1231 as an ordinary loss. For the purposes of this special rule, the term "involuntary conversion" means a compulsory or involuntary conversion of property into other property or money as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof; and the term "other disposition" includes the destruction or loss, in whole or in part, of property by fire, storm, shipwreck, or other casualty, or by theft, even though there is no conversion of such property into other property or money.

(ii) The application of this subparagraph may be illustrated by the following example:

Example.—During the taxable year 1954, A, who owns a grocery store, realized a net profit of $1,500 from the sale of groceries and a gain of $350 from the sale of a refrigerator case. During the same year, he sustained a loss of $2,000 as a result of damage by fire to the store building. In computing taxable income, all of these items are taken into account. In determining net earnings from self-employment, however, only the $1,500 of profit derived from the sale of groceries is included. The $350 gain and the $2,000 loss are excluded.

(4) *Net operating loss deduction.*—The deduction provided by section 172, relating to net operating losses sustained in years other than the taxable year, is excluded.

(5) *Community income*—(i) *In case of an individual.*—If any of the income derived by an individual from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income,

all of the gross income, and the deductions attributable to such income, shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife. For the purpose of this special rule, the term "management and control" means management and control in fact, not the management and control imputed to the husband under the community property laws. For example, a wife who operates a beauty parlor without any appreciable collaboration on the part of her husband will be considered as having substantially all of the management and control of such business despite the provision of any community property law vesting in the husband the right of management and control of community property; and the income and deductions attributable to the operation of such beauty parlor will be considered the income and deductions of the wife.

(ii) *In case of a partnership.*—Even though a portion of a partner's distributive share of the income or loss, described in section 702(a) (9), from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner; no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner. In any case in which both spouses are members of the same partnership, the distributive share of the income or loss of each spouse is included in computing the net earnings from self-employment of that spouse.

(6) *Puerto Rico*—(i) *Residents.*—A resident of Puerto Rico, whether or not a bona fide resident thereof during the entire taxable year, and whether or not an alien, a citizen of the United States, or a citizen of Puerto Rico, shall compute his net earnings from self-employment in the same manner as would a citizen of the United States residing in the United States. See paragraph (d) of § 1.1402(b)–1 for rules relating to nonresident aliens. For the purpose of the tax on self-employment income, the gross income of such a resident of Puerto Rico also includes income from Puerto Rican sources. Thus, under this special rule, income from Puerto Rican sources will be included in determining net earnings from self-employment of a resident of Puerto Rico engaged in the active conduct of a trade or business in Puerto Rico despite the fact that, under section 933, such income may not be taken into account for purposes of the tax under section 1 or 3.

(ii) *Nonresidents.*—A citizen of Puerto Rico who is also a citizen of the United States and who is not a resident of Puerto Rico will compute his net earnings from self-employment in the same manner and subject to the same provisions of law and regulations as other citizens of the United States.

(7) *Personal exemption deduction.*—The deduction provided by section 151, relating to personal exemptions, is excluded.

(8) *Ministers and members of religious orders.*—(i) For each taxable year ending after 1954 in which a minister or member of a religious order is engaged in a trade or business, within the meaning of

section 1402(c) and paragraph (e) of § 1.1402(c)-1, with respect to service performed in the exercise of his ministry or in the exercise of duties required by such order, net earnings from self-employment from such trade or business include the gross income derived during the taxable year from any such service, less the deductions attributable to such gross income. If a minister or member of a religious order engaged in such a trade or business is a citizen of the United States and performs service, in his capacity as a minister or member of a religious order, as an employee of an American employer, as defined in section 3121(h) and subdivision (ii) of this subparagraph, his net earnings from self-employment derived from such service shall be computed without regard to the exclusions from gross income provided in section 911, relating to earned income from sources without the United States, and section 931, relating to income from sources within possessions of the United States. Thus, even though all the income of the minister or member for service of the character to which this subparagraph is applicable was derived from sources without the United States, or from sources within possessions of the United States, and therefore may be excluded from gross income, such income is included in computing net earnings from self-employment.

(ii) For the purpose of this subparagraph, the term "American employer" means an employer which is—

(*a*) The United States or any instrumentality thereof,

(*b*) An individual who is a resident of the United States (that is, the several States, the District of Columbia, the Territories of Alaska and Hawaii, the Virgin Islands, and Puerto Rico),

(*c*) A partnership, if two-thirds or more of the partners are residents of the United States,

(*d*) A trust, if all of the trustees are residents of the United States, or

(*e*) A corporation organized under the laws of the United States or of any State (including the District of Columbia, the Territories of Alaska and Hawaii, the Virgin Islands, and Puerto Rico).

(9) *Income from agricultural activity*—(i) *Taxable years ending before 1955.*—(*a*) Income derived in a taxable year ending before 1955 from any trade or business in which, if the trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g), and all deductions attributable to such income, are excluded. In case the services are in part agricultural and in part nonagricultural, the time devoted to the performance of each type of service is the test to be used to determine whether the major portion of the services would constitute agricultural labor. If more than half of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 3121(g), all income, and the deductions attributable to the income, shall be excluded. If only half, or less, of the time spent in performing all the services is spent in performing services which would constitute agricultural labor under section 3121(g), all income, and the deductions attributable to the income, shall be included. In every case the time spent in performing the services will be computed by adding the time spent in

the trade or business during the taxable year by every individual (including the individual carrying on such trade or business and the members of his family) in performing such services. The operation of this special rule is not affected by section 3121(c), relating to the included-excluded rule for determining employment.

(*b*) The rules prescribed in (*a*) of this subdivision have no application where the nonagricultural services are performed in connection with an enterprise which constitutes a trade or business separate and distinct from the trade or business conducted as an agricultural enterprise. Thus, the operation of a roadside automobile service station on farm premises constitutes a trade or business separate and distinct from the agricultural enterprise, and the gross income derived from such service station, less the deductions attributable thereto, is to be taken into account in determining net earnings from self-employment.

(ii) *Taxable years ending after 1954.*—Income derived in a taxable year ending after 1954 from agricultural activities (see subdivision (i) of this subparagraph) is includible in computing net earnings from self-employment. Income derived from agricultural activities includes income derived by an individual under an agreement entered into by such individual with another person pursuant to which such individual undertakes to produce a crop or livestock on land owned or leased by such other person and pursuant to which (*a*) the crop or livestock produced by such individual, or the proceeds thereof, are to be divided between such individual and such other person, and (*b*) the amount of such individual's share depends on the amount of the crop or livestock produced. However, the income derived under such an agreement by the owner or lessee of the land is not includible in computing net earnings from self-employment. See subparagraph (1) of this paragraph. For options relating to the computation of net earnings from self-employment, see paragraph (d) of this section.

(d) *Options available to farmers in computing net earnings from self-employment for taxable years ending after 1954*—(1) *Computation of net earnings.*—In the case of any trade or business which is carried on by an individual who reports his income on the cash receipts and disbursements method, and in which, if it were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g) (see paragraph (c)(9)(i) of this section), net earnings from self-employment may for a taxable year ending after 1954, at the option of the taxpayer, be computed as follows:

(i) *Gross income $1,800 or less.*—If the gross income, computed as provided in subparagraph (2) of this paragraph, from such trade or business is $1,800 or less, the taxpayer may, at his option, treat as net earnings from self-employment from such trade or business an amount equal to 50 percent of such gross income. If the taxpayer so elects, the amount equal to 50 percent of such gross income shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any.

(ii) *Gross income in excess of $1,800.*—If the gross income, computed as provided in subparagraph (2) of this paragraph, from such trade or business is more than $1,800, and the actual net earnings from self-employment from such trade or business are less than $900, the

taxpayer may, at his option, treat $900 as net earnings from self-employment. If the taxpayer so elects, $900 shall be used in computing his self-employment income in lieu of his actual net earnings from such trade or business, if any. However, if the taxpayer's actual net earnings from such trade or business, as computed in accordance with paragraphs (a), (b), and (c) of this section, are $900 or more, such actual net earnings shall be used in computing his self-employment income.

(2) *Computation of gross income.*—For purposes of subparagraph (1) of this paragraph, gross income shall consist of the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraph (c) of this section, relating to income and deductions not included in computing net earnings from self-employment.

(3) *Examples.*—Application of the rules prescribed in subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1).—F, a farmer, uses the cash receipts and disbursements method of accounting in making his income tax returns. F's books and records show that during the calendar year 1955 he received $1,200 from the sale of produce raised on the farm, $200 from the sale of livestock raised on the farm and not held for breeding or dairy purposes, and $600 from the sale of a tractor. The income from the sale of the tractor is of a type which is excluded from net earnings from self-employment by section 1402(a). F's actual net earnings from self-employment, computed in accordance with the provisions of paragraphs (a), (b), and (c) of this section, are $450. F may report $450 as his net earnings from self-employment or he may elect to report $700 (one-half of $1,400).

Example (2).—C, a cattleman, uses the cash receipts and disbursements method of accounting in making his income tax returns. C had actual net earnings from self-employment, computed in accordance with the provisions of paragraphs (a), (b), and (c) of this section, of $725. His gross receipts were $1,000 from the sale of produce raised on the farm and $1,200 from the sale of feeder cattle, which C bought for $500. The income from the sale of the feeder cattle is of a type which is included in computing net earnings from self-employment. Therefore, C may report $725 as his net earnings from self-employment or he may elect to report $850, one-half of $1,700 ($2,200 minus $500).

Example (3).—R, a rancher, has gross income of $3,000 from the operation of his ranch, computed as provided in subparagraph (2) of this paragraph. His actual net earnings from self-employment from farming activities are less than $900. R, nevertheless, may elect to report $900 as net earnings from self-employment from such trade or business. If R had actual net earnings from self-employment from his farming activities in the amount of $900 or more, he would be required to report such amount in computing his self-employment income.

(4) *Two or more agricultural activities.*—If an individual is en gaged in more than one agricultural trade or business within the mean ing of paragraph (c)(9)(i) of this section (for example, the busines of ordinary farming and the business of cotton ginning), the gross in come derived from each agricultural trade or business shall be aggre gated for purposes of the optional method provided in subparagrap (1) of this paragraph for computing net earnings from self-employ ment.

(5) *Exercise of option.*—A taxpayer shall, for each taxable yea with respect to which he is eligible to use the optional method pro vided by subparagraph (1) of this paragraph, make a determinatio as to whether his net earnings from self-employment are to be com puted in accordance with the optional method. If the taxpayer elect the optional method for a taxable year, he shall signify such electio by computing net earnings from self-employment under the optiona method as set forth in Schedule F (Form 1040) of the income tax retur filed by the taxpayer for such taxable year. If the optional method i not elected at the time of the filing of the return for a taxable yea with respect to which the taxpayer is eligible to elect such optiona method, such method may be elected on an amended return (or o such other form as may be prescribed for such use) filed within th period prescribed by section 6501 and the regulations thereunder fo the assessment of the tax for such taxable year. If the optional metho is elected on a return for a taxable year, the taxpayer may revok such election by filing an amended return (or such other form as ma be prescribed for such use) for the taxable year within the period pre scribed by section 6501 and the regulations thereunder for the assess ment of the tax for such taxable year. If the taxpayer is deceased o unable to make a return, the person designated in section 6012(b) an the regulations thereunder may, within the period prescribed in thi subparagraph, elect the optional method for any taxable year wit respect to which the taxpayer is eligible to use the optional metho and revoke an election previously made by or for the taxpayer.

(6) *Members of farm partnerships.*—The optional method provide by subparagraph (1) of this paragraph for computing net earning from self-employment is not available to a member of a partnershi with respect to his distributive share of the income or loss from an trade or business carried on by any partnership of which he is member.

§ 1.1402(b) STATUTORY PROVISIONS; DEFINITIONS; SELF-EMPLOY MENT INCOME.

SEC. 1402. DEFINITIONS. * * *

(b) SELF-EMPLOYMENT INCOME.—The term "self-employment income" means the net earnings from self-employment derived by an individual (other than a nonresident alien individual) during any taxable year; except that such term shall not include—

(1) that part of the net earnings from self-employment which is in excess of—

(A) for any taxable year ending prior to 1955, (i) $3,600, minus (ii) the amount of the wages paid to such individual during the taxable year; and

(B) for any taxable year ending after 1954, (i) $4,200, minus (ii) the amount of the wages paid to such individual during the taxable year; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of clause (1), the term "wages" includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 218 of the Social Security Act (relating to coverage of State employees), or under an agreement entered into pursuant to the provisions of section 3121 (l) (relating to coverage of citizens of the United States who are employees of foreign subsidiaries of domestic corporations), as would be wages under section 3121(a) if such services constituted employment under section 3121(b). An individual who is not a citizen of the United States but who is a resident of the Virgin Islands or a resident of Puerto Rico shall not, for purposes of this chapter be considered to be a nonresident alien individual.

[Sec. 1402(b) as amended by sec. 201(b), Social Security Amendments of 1954, for taxable years ending after 1954. For taxable years ending before 1955, sec. 1402(b), as set forth below, is applicable.

SEC. 1402. DEFINITIONS. * * *

(b) SELF-EMPLOYMENT INCOME.—The term "self-employment income" means the net earnings from self-employment derived by an individual (other than a nonresident alien individual) during any taxable year; except that such term shall not include—

(1) that part of the net earnings from self-employment which is in excess of—

(A) $3,600, minus

(B) the amount of the wages paid to such individual during the taxable year; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than $400.

For purposes of clause (1), the term "wages" includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 218 of the Social Security Act (relating to coverage of State employees) as would be wages under section 3121(a) if such services constituted employment under section 3121(b). An individual who is not a citizen of the United States but who is a resident of the Virgin Islands or a resident of Puerto Rico shall not, for purposes of this chapter be considered to be a nonresident alien individual.]

§ 1.1402(b)–1 SELF-EMPLOYMENT INCOME—(a) *In general.*—Except for the exclusions in paragraphs (b) and (c) of this section and the exception in paragraph (d) of this section, the term "self-employment income" means the net earnings from self-employment derived by an individual during a taxable year.

(b) *Maximum self-employment income.*—(1) The maximum self-employment income of an individual for any taxable year (whether a period of 12 months or less) is $4,200, except that the maximum self-employment income for any taxable year ending before 1955 is $3,600. If an individual is paid wages as defined in section 3121(a), the maximum self-employment income is the excess of $4,200 ($3,600 for a taxable year ending before 1955) over the amount of such wages. For example, if during the taxable year 1955 no such wages are paid and the individual has $5,000 of net earnings from self-employment, he has $4,200 of self-employment income for such taxable year. If, in addition to having $5,000 of net earnings from self-employment, such individual is paid $1,000 of such wages, he has only $3,200 of self-employment income for the taxable year.

(2) For the purpose of the limitation prescribed in subparagra (1) of this paragraph, the term "wages" includes such remunerati paid to an employee for services covered by—

(i) An agreement entered into pursuant to section 218 of t Social Security Act (42 U. S. C. 418), which section provides f extension of the Federal old-age and survivors insurance system State and local government employees under voluntary agreemer between the States and the Secretary of Health, Education, a Welfare (Federal Security Administrator before April 11, 195 or

(ii) An agreement entered into pursuant to the provisions section 3121(l), relating to coverage of citizens of the Unit States who are employees of foreign subsidiaries of domes corporations,

as would be wages under section 3121(a) if such services constitut employment under section 3121(b). For an explanation of the te "wages," see Subpart B of the Employment Tax Regulations (Pa 31 of this Chapter).

(c) *Minimum net earnings from self-employment.*—Self-emplo ment income does not include the net earnings from self-employment an individual when the amount of such earnings for the taxable year less than $400. Thus, an individual having only $300 of net earnin from self-employment for the taxable year would not have any se employment income. However, an individual having net earnin from self-employment of $400 or more for the taxable year may ha less than $400 of self-employment income. This would occur in a ca in which the amount of the individual's net earnings from self-emplo ment is $400 or more for a taxable year and the amount of such r earnings from self-employment plus the amount of the wages receiv by the individual during that taxable year exceed $4,200 ($3,600 f taxable years ending before 1955). For example, if an individual h net earnings from self-employment of $1,000 for 1955 and also receiv wages of $4,000 during that taxable year, his self-employment inco for that taxable year is $200.

(d) *Nonresident aliens.*—A nonresident alien individual never h self-employment income. For the purpose of the tax on self-emplo ment income, an individual who is not a citizen of the United Sta but who is a resident of the Virgin Islands or of Puerto Rico is not co sidered to be a nonresident alien individual. While a nonreside alien individual who derives income from a trade or business carri on within the United States, Puerto Rico, or the Virgin Islan (whether by agents or employees, or by a partnership of which he a member) may be subject to the applicable income tax provisions such income, such nonresident alien individual will not be subject the tax on self-employment income, since any net earnings which may have from self-employment do not constitute self-employme income.

§ 1.1402(b)–1(b)(2)

§ 1.1402(c) STATUTORY PROVISIONS; DEFINITIONS; TRADE OR BUSINESS.

SEC. 1402. DEFINITIONS. * * *

(c) TRADE OR BUSINESS.—The term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) the performance of the functions of a public office;

(2) the performance of service by an individual as an employee (other than service described in section 3121(b)(14)(B) performed by an individual who has attained the age of 18 and other than service described in paragraph (4) of this subsection);

(3) the performance of service by an individual as an employee or employee representative as defined in section 3231;

(4) the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; or

(5) the performance of service by an individual in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, or Christian Science practitioner; or the performance of such service by a partnership.

The provisions of paragraph (4) shall not apply to service (other than service performed by a member of a religious order who has taken a vow of poverty as a member of such order) performed by an individual during the period for which a certificate filed by such individual under subsection (e) is in effect. The provisions of paragraph (5) shall not apply to service performed by an individual in the exercise of his profession as a Christian Science practitioner during the period for which a certificate filed by him under subsection (e) is in effect.

[SEC. 1402(c) as amended by secs. 201(c) and 205(e), Social Security Amendments of 1954, for taxable years ending after 1954. For taxable years ending before 1955, sec. 1402(c), as set forth below, is applicable.

SEC. 1402. DEFINITIONS. * * *

(c) TRADE OR BUSINESS.—The term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) the performance of the functions of a public office;

(2) the performance of service by an individual as an employee (other than service described in section 3121(b)(16)(B) performed by an individual who has attained the age of 18);

(3) the performance of service by an individual as an employee or employee representative as defined in section 3231;

(4) the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order; or

(5) the performance of service by an individual in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer; or the performance of such service by a partnership.]

§ 1.1402(c)–1 TRADE OR BUSINESS.—(a) *In general.*—In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Except for the exclusions discussed in paragraphs (b), (c), (d), (e), and (f) of this section, the term "trade or business", for the purpose of the tax on self-employment income, shall

have the same meaning as when used in section 162. An individua engaged in one of the excluded activities specified in this section ma also be engaged in carrying on an included trade or business Whether or not he is also engaged in an included trade or busines will be dependent upon all of the facts and circumstances in the par ticular case.

(b) *Public office.*—The performance of the functions of a publi office does not constitute a trade or business. The term "public office includes any elective or appointive office of the United States or an possession thereof, or of a State or its political subdivisions, or of wholly owned instrumentality of any one or more of the foregoing For example, the President, the Vice President, a governor, a mayor the Secretary of State, a member of Congress, a State representative a county commissioner, a judge, a county or city attorney, a marsha a sheriff, a register of deeds, or a notary public performs the function of a public office.

(c) *Employees.*—The performance of service by an individual as a employee, as defined in the Federal Insurance Contributions Ac (chapter 21 of the Internal Revenue Code), with two exceptions, doe not constitute a trade or business. The exceptions are as follows:

(1) Service performed by an individual, who has attained th age of 18, in, and at the time of, the sale of newspapers or maga zines to ultimate consumers, under an arrangement under whic the newspapers or magazines are to be sold by him at a fixed price his compensation being based on the retention of the excess o such price over the amount at which the newspapers or magazine are charged to him, whether or not he is guaranteed a minimum amount of compensation for such service, or is entitled to be cred ited with the unsold newspapers or magazines turned back, and

(2) Service described in section 1402(c)(4) performed by a individual during taxable years for which a certificate filed i accordance with the provisions of § 1.1402(e)-1 is in effect. Se also paragraph (e) of this section.

As to when an individual is an employee, see Regulations 128 (2 CFR, 1939, Part 408) and Subpart B of the Employment Tax Regu lations (Part 31 of this Chapter), both of which relate to the Federa Insurance Contributions Act.

(d) *Individuals under Railroad Retirement System.*—The perform ance of service by an individual as an employee or employee rep resentative as defined in section 3231(b) and (c), respectively (se §§ 31.3231(b)-1 and 31.3231(c)-1 of the Employment Tax Regula tions (Part 31 of this Chapter)), that is, an individual covered unde the railroad retirement system, does not constitute a trade or business

(e) *Ministers and members of religious orders*—(1) *In general.*— For taxable years ending before 1955, a duly ordained, commissioned or licensed minister of a church or a member of a religious order i not engaged in carrying on a trade or business with respect to servic performed by him in the exercise of his ministry or in the exercise o duties required by such order. However, for taxable years endin after 1954, any individual who is a duly ordained, commissioned, o licensed minister of a church or a member of a religious order (othe

than a member of a religious order who has taken a vow of poverty as a member of such order) may elect, as provided in § 1.1402(e)–1, to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to service performed by him in his capacity as such a minister or member. If such a minister or a member of a religious order makes an election pursuant to § 1.1402(e)–1, he is, with respect to service performed by him in such capacity, engaged in carrying on a trade or business for each taxable year to which the election is effective. An election by a minister or member of a religious order has no application to service performed by such minister or member which is not in the exercise of his ministry or in the exercise of duties required by such order.

(2) *Service by a minister in the exercise of his ministry.*—(i) A certificate of election filed by a duly ordained, commissioned, or licensed minister of a church under the provisions of § 1.1402(e)–1 has application only to service performed by him in the exercise of his ministry.

(ii) Except as provided in subparagraph (3)(iii) of this paragraph, service performed by a minister in the exercise of his ministry includes the ministration of sacerdotal functions and the conduct of religious worship, and the control, conduct, and maintenance of religious organizations (including the religious boards, societies, and other integral agencies of such organizations), under the authority of a religious body constituting a church or church denomination. The following rules are applicable in determining whether services performed by a minister are performed in the exercise of his ministry:

(*a*) Whether service performed by a minister constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting his church or church denomination.

(*b*) Service performed by a minister in the control, conduct, and maintenance of a religious organization relates to directing, managing, or promoting the activities of such organization. Any religious organization is deemed to be under the authority of a religious body constituting a church or church denomination if it is organized and dedicated to carrying out the tenets and principles of a faith in accordance with either the requirements or sanctions governing the creation of institutions of the faith. The term "religious organization" has the same meaning and application as is given to the term for income tax purposes.

(*c*)(*1*) If a minister is performing service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of his ministry whether or not it is performed for a religious organization.

(*2*) The rule in (*c*)(*1*) of this subdivision may be illustrated by the following example:

Example.—M, a duly ordained minister, is engaged to perform service as chaplain at N University. M devotes his entire time to performing his duties as chaplain which include the conduct of religious worship, offering spiritual counsel to the university stu-

dents, and teaching a class in religion. M is performing servic in the exercise of his ministry.

(*d*) (*1*) If a minister is performing service for an organizatio which is operated as an integral agency of a religious organizatio under the authority of a religious body constituting a church o church denomination, all service performed by the minister in th conduct of religious worship, in the ministration of sacerdota functions, or in the control, conduct, and maintenance of sucl organization (see subdivision (ii)(b) of this subparagraph) is in the exercise of his ministry.

(*2*) The rule in (*d*) (*1*) of this subdivision may be illustrated by the following example:

Example.—M, a duly ordained minister, is engaged by the N Religious Board to serve as director of one of its departments. H performs no other service. The N Religious Board is an integra agency of O, a religious organization operating under the authority of a religious body constituting a church denomination. M is per forming service in the exercise of his ministry.

(*e*) (*1*) If a minister, pursuant to an assignment or designatio by a religious body constituting his church, performs service fo an organization which is neither a religious organization nor oper ated as an integral agency of a religious organization, all servic performed by him, even though such service may not involve th conduct of religious worship or the ministration of sacerdotal func tions, is in the exercise of his ministry.

(*2*) The rule in (*e*) (*1*) of this subdivision may be illustrated b the following example:

Example.—M, a duly ordained minister, is assigned by X, th religious body constituting his church, to perform advisory servic to Y Company in connection with the publication of a book dealin with the history of M's church denomination. Y is neither a reli gious organization nor operated as an integral agency of a religiou organization. M performs no other service for X or Y. M i performing service in the exercise of his ministry.

(3) *Service by a minister not in the exercise of his ministry.*—(i) A certificate filed by a duly ordained, commissioned, or licensed ministe of a church under the provisions of § 1.1402(e)-1 has no applicatio to service performed by him which is not in the exercise of hi ministry.

(ii) (*a*) If a minister is performing service for an organizatio which is neither a religious organization nor operated as an integra agency of a religious organization and the service is not performe pursuant to an assignment or designation by his ecclesiastical supe riors, then only the service performed by him in the conduct of reli gious worship or the ministration of sacerdotal functions is in th exercise of his ministry. See, however, subdivision (iii) of this sub paragraph.

(*b*) The rule in (*a*) of this subdivision may be illustrated by th following example:

Example.—M, a duly ordained minister, is engaged by N Univer sity to teach history and mathematics. He performs no other servic

for N although from time to time he performs marriages and conducts funerals for relatives and friends. N University is neither a religious organization nor operated as an integral agency of a religious organization. M is not performing the service for N pursuant to an assignment or designation by his ecclesiastical superiors. The service performed by M for N University is not in the exercise of his ministry. However, service performed by M in performing marriages and conducting funerals is in the exercise of his ministry.

(iii) Service performed by a duly ordained, commissioned, or licensed minister of a church as an employee of the United States, or a State, Territory, or possession of the United States, or the District of Columbia, or a foreign government, or a political subdivision of any of the foregoing, is not considered to be in the exercise of his ministry for purposes of the tax on self-employment income, even though such service may involve the ministration of sacerdotal functions or the conduct of religious worship. Thus, for example, service performed by an individual as a chaplain in the Armed Forces of the United States is considered to be performed by a commissioned officer in his capacity as such, and not by a minister in the exercise of his ministry. Similarly, service performed by an employee of a State as a chaplain in a State prison is considered to be performed by a civil servant of the State and not by a minister in the exercise of his ministry.

(4) *Service in the exercise of duties required by a religious order.*—A certificate of election filed by a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) under the provisions of § 1.1402(e)–1 has application to all duties required of him by such order. The nature or extent of such service is immaterial so long as it is a service which he is directed or required to perform by his ecclesiastical superiors.

(f) *Members of certain professions*—(1) *Taxable years ending before 1955.*—For taxable years ending before 1955, an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, Christian Science practitioner, architect, certified public accountant, accountant registered or licensed as an accountant under State or municipal law, full-time practicing public accountant, funeral director, or professional engineer.

(2) *Taxable years ending after 1954.*—(i) Except as provided in subdivision (ii) of this subparagraph, for taxable years ending after 1954 an individual is not engaged in carrying on a trade or business with respect to the performance of service in the exercise of his profession as a physician, lawyer, dentist, osteopath, veterinarian, chiropractor, naturopath, optometrist, or Christian Science practitioner.

(ii) For taxable years ending after 1954, a Christian Science practitioner may elect, as provided in § 1.1402(e)–1, to have the Federal old-age and survivors insurance system established by title II of the

Social Security Act extended to service performed by him in the exercise of his profession as a Christian Science practitioner. If an election is made pursuant to § 1.1402(e)-1, the Christian Science practitioner is, with respect to the performance of service in the exercise of such profession, engaged in carrying on a trade or business for each taxable year to which the election is effective. An election by a Christian Science practitioner has no application to service performed by him which is not in the exercise of his profession as a Christian Science practitioner.

(3) *Legal requirements.*—The exclusions specified in subparagraphs (1) and (2) of this paragraph apply only if the individuals meet the legal requirements, if any, for practicing their professions in the place where they perform the service. Thus, an individual who is not licensed as a veterinarian but who is publicly engaged in the practice of veterinary medicine in a jurisdiction which requires that an individual engaged in such practice be licensed is not within the exclusion.

(4) *Meaning of terms.*—The designations in subparagraphs (1) and (2) of this paragraph are to be given their commonly accepted meaning. Thus, the term "physician" means an individual who is legally qualified to practice medicine, and the term "lawyer" means an individual who is legally qualified to practice law.

(5) *Partnerships.*—In the case of a partnership engaged in the practice of any of the designated excluded professions, the partnership shall not be considered as carrying on a trade or business for the purpose of the tax on self-employment income, and none of the distributive shares of the income or loss, described in section 702(a)(9), of such partnership shall be included in computing net earnings from self-employment of any member of the partnership. On the other hand, where a partnership is engaged in a trade or business not within any of the designated excluded professions, each partner must include his distributive share of the income or loss, described in section 702(a)(9), of such partnership in computing his net earnings from self-employment, irrespective of whether such partner is engaged in the practice of one or more of such professions and contributes his professional services to the partnership.

§ 1.1402(d) STATUTORY PROVISIONS; DEFINITIONS; EMPLOYEE AND WAGES.

SEC. 1402. DEFINITIONS. * * *

(d) EMPLOYEE AND WAGES.—The term "employee" and the term "wages" shall have the same meaning as when used in chapter 21 (sec. 3101 and following, relating to Federal Insurance Contributions Act).

§ 1.1402(d)-1 EMPLOYEE AND WAGES.—For the purpose of the tax on self-employment income, the term "employee" and the term "wages" shall have the same meaning as when used in the Federal Insurance Contributions Act. For an explanation of these terms, see Regulations 128 (26 CFR (1939) Part 408) and Subpart B of the Employment Tax Regulations (Part 31 of this chapter).

§ 1.1402(e) STATUTORY PROVISIONS; DEFINITIONS; MINISTERS, MEMBERS OF RELIGIOUS ORDERS, AND CHRISTIAN SCIENCE PRACTITIONERS.

SEC. 1402. DEFINITIONS. * * *

(e) MINISTERS, MEMBERS OF RELIGIOUS ORDERS, AND CHRISTIAN SCIENCE PRACTITIONERS.—

(1) WAIVER CERTIFICATE.—Any individual who is (A) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (B) a Christian Science practitioner may file a certificate (in such form and manner, and with such official, as may be prescribed by regulations made under this chapter) certifying that he elects to have the insurance system established by title II of the Social Security Act extended to service described in subsection (c)(4), or service described in subsection (c)(5) insofar as it relates to the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, as the case may be, performed by him.

(2) TIME FOR FILING CERTIFICATE.—Any individual who desires to file a certificate pursuant to paragraph (1) must file such certificate on or before the due date of the return (including any extension thereof) for his second taxable year ending after 1954 for which he has net earnings from self-employment (computed, in the case of an individual referred to in paragraph (1)(A), without regard to subsection (c)(4), and, in the case of an individual referred to in paragraph (1)(B), without regard to subsection (c)(5) insofar as it relates to the performance of service by an individual in the exercise of his profession as a Christian Science practitioner) of $400 or more, any part of which was derived from the performance of service described in subsection (c)(4), or from the performance of service described in subsection (c)(5) insofar as it relates to the performance of service by an individual in the exercise of his profession as a Christian Science practitioner, as the case may be.

(3) EFFECTIVE DATE OF CERTIFICATE.—A certificate filed pursuant to this subsection shall be effective for the first taxable year with respect to which it is filed (but in no case shall the certificate be effective for a taxable year with respect to which the period for filing a return has expired, or for a taxable year ending prior to 1955) and all succeeding taxable years. An election made pursuant to this subsection shall be irrevocable.

[Sec. 1402(e) as added by sec. 201(c)(3), Social Security Amendments of 1954.]

§ 1.1402(e)-1 ELECTION BY MINISTERS, MEMBERS OF RELIGIOUS ORDERS, AND CHRISTIAN SCIENCE PRACTITIONERS FOR SELF-EMPLOYMENT COVERAGE—(a) *In general.*—Any individual who is (1) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (2) a Christian Science practitioner may elect to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to service performed by him in the exercise of his ministry or in the exercise of duties required by such order, or in the exercise of his profession as a Christian Science practitioner, as the case may be. Such an election shall be made by filing a certificate on Form 2031 in the manner provided in paragraph (b) of this section and within the time specified in paragraph (c) of this section. If a minister or member to whom this paragraph has application, or a Christian Science practitioner, makes an election by filing Form 2031 such individual shall, for each taxable year to which the election is

effective (see paragraph (d) of this section), be considered as carrying on a trade or business with respect to the performance of service in his capacity as such a minister or member, or as a Christian Science practitioner, as the case may be.

(b) *Waiver certificate.*—(1) The certificate on Form 2031 shall be filed in triplicate with the district director of internal revenue for the internal revenue district in which is located the legal residence or principal place of business of the individual who executed the certificate. If such individual has no legal residence or principal place of business in the United States, Puerto Rico, or the Virgin Islands, such certificate shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland. The certificate must be filed within the time prescribed in paragraph (c) of this section. If an individual to whom this section has application submits to a district director of internal revenue a dated and signed statement indicating that he desires to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his services, such statement will be treated as a waiver certificate, if filed within the time specified in paragraph (c) of this section, provided that without unnecessary delay such statement is supplemented by a properly executed Form 2031.

(2) An application for a social security account number filed on Form SS-5 or the filing of an income tax return showing an amount representing self-employment income or self-employment tax shall not be construed to constitute an election referred to in paragraph (a) of this section.

(c) *Time limitation for filing waiver certificate.*—(1) (i) Any individual referred to in paragraph (a) of this section who desires to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his services must file the waiver certificate (Form 2031) prescribed by paragraph (a) of this section on or before the due date of the income tax return (see section 6072), including any extension thereof (see section 6081), for his second taxable year ending after 1954 for which he has net earnings from self-employment (computed as prescribed in subparagraph (3) of this paragraph) of $400 or more, any part of which—

(*a*) In the case of a duly ordained, commissioned, or licensed minister of a church, consists of remuneration for service performed in the exercise of his ministry,

(*b*) In the case of a member of a religious order who has not taken a vow of poverty as a member of such order, consists of remuneration for services performed in the exercise of duties required by such order.

(*c*) In the case of a Christian Science practitioner, consists of remuneration for service performed in the exercise of his profession as a Christian Science practitioner.

Thus, a minister who performs service in the exercise of his ministry and who makes his income tax returns on the basis of a calendar year and has, for each of the calendar years 1955 and 1956, net earnings from self-employment of $400 or more (computed as prescribed in subparagraph (3) of this paragraph), a portion of which was derived from such service, may not make an election with respect to his service

as a minister after the due date (April 15, 1957) prescribed for filing his income tax return for 1956, or any extension thereof. If a minister, a member of a religious order, or a Christian Science practitioner receives remuneration in a taxable year for service performed in such capacity and the deductions allowed by chapter 1 of the Internal Revenue Code, which are attributable to the portion of such remuneration which constitutes gross income, equal or exceed the amount of such gross income, no part of the net earnings from self-employment (computed as prescribed in subparagraph (3) of this paragraph) for such taxable year shall be considered to consist of remuneration for such service. See, however, paragraph (d) of this section for provisions relating to the effective period of the waiver certificate.

(ii) The application of the rule set forth in subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1).—M, a licensed minister, has been employed as a toolmaker by the XYZ Corporation for the taxable years 1955 and 1956 and also engages in activities as a minister on week-ends. M makes his income tax returns on the basis of a calendar year. During each of the taxable years 1955 and 1956, M received wages of $4,200 from the XYZ Corporation and derived $400 (all of which constituted net earnings from self-employment computed as prescribed in subparagraph (3) of this paragraph) from his activities as a minister. In such case if M wishes to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his services as a minister, he must file the waiver certificate on or before the due date (April 15, 1957), prescribed for filing his income tax return for 1956, or any extension thereof. A waiver certificate filed after such date will be invalid.

Example (2).—M was ordained as a minister in May 1956. During each of the taxable years 1956 and 1958, M, who makes his income tax returns on a calendar year basis, derived net earnings in excess of $400 from his activities as a minister. M had net earnings of $350 for the taxable year 1957, $200 of which was derived from service performed by him as a minister. If M wishes to have the Federal old-age and survivors insurance system established by title II of the Social Security Act extended to his service as a minister, he must file the waiver certificate on or before the due date (April 15, 1959) prescribed for filing his income tax return for 1958, or any extension thereof.

(2) The right of an individual to file a waiver certificate shall cease from his death. Thus, the surviving spouse, administrator, or executor of a decedent shall not be permitted to file a waiver certificate for such decedent.

(3) For the purpose of this paragraph, net earnings from self-employment shall be determined without regard to the fact that, without an election, the performance of services by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, or by a member of a religious order in the exercise of duties required by such order, or the performance of service by an individual

in the exercise of his profession as a Christian Science practitioner does not constitute a trade or business for purposes of the tax on self-employment income.

(d) *Effective date of waiver certificate.*—(1) A certificate on Form 2031 filed in accordance with the provisions of this section shall be effective for the first taxable year with respect to which it is filed and all subsequent taxable years. A certificate must be made effective for either the first or second taxable year ending after 1954 in which the individual has net earnings from self-employment of $400 (determined as provided in paragraph (c)(3) of this section) from service of the character with respect to which an election may be made. However, a certificate on Form 2031 may not be effective, even though filed within the time specified in paragraph (c)(1) of this section, for any taxable year with respect to which the due date for filing the individual's income tax return (including any extension thereof) has expired at the time such certifiate is filed. Further, a certificate on Form 2031 may not be effective for any taxable year ending before 1955. In order for an election to be effective for the first or second taxable year ending after 1954 in which the individual has net earnings from self-employment (determined as provided in paragraph (c)(3) of this section) from service of the character with respect to which an election may be made, the certificate on Form 2031 must be filed on or before the due date for filing the income tax return of the individual for such first or second taxable year, or of any extension thereof. Thus, if an individual makes his income tax returns on a calendar year basis and the due date of his return for the calendar year 1955 is April 15, 1956, a waiver certificate, to be effective for the calendar year 1955, must be filed on or before April 15, 1956. If such individual files a certificate after April 15, 1956, and before the due date of his income tax return for 1956, the first taxable year for which the certificate may be effective is the calendar year 1956.

(2) If an individual makes an election to become effective beginning with respect to any taxable year, such election shall be effective with respect to such taxable year unless the individual, on or before the due date for filing the income tax return for such taxable year (including any extension thereof), files, with the district director of internal revenue with whom the certificate on Form 2031 was filed, a written notice of his desire to withdraw the certificate. If the individual is deceased or unable to make a return, the written notice of withdrawal of the certificate on Form 2031 may be filed for or on behalf of the individual by the person designated in section 6012(b) and the regulations thereunder. In the absence of a withdrawal of a certificate on or before the due date for filing the income tax return for the taxable year (including any extension thereof), the election shall be effective with respect to such taxable year and all subsequent taxable years provided all the provisions of this section are met.

(3) A certificate filed and intended to be effective for a particular taxable year which for any reason is ineffective for such taxable year shall become effective with respect to the next succeeding taxable year provided the requirements of paragraph (c) of this section are met with respect to such taxable year.

§ 1.1402(e)–1(d)(1)

(4) An election which has become effective in accordance with the provisions of this section is irrevocable.

§ 1.1403 STATUTORY PROVISIONS; MISCELLANEOUS PROVISIONS.

SEC. 1403. MISCELLANEOUS PROVISIONS.

(a) TITLE OF CHAPTER.—This chapter may be cited as the "Self-Employment Contributions Act of 1954".

(b) CROSS REFERENCES.—

(1) For provisions relating to returns, see section 6017.

(2) For provisions relating to collection of taxes in Virgin Islands and Puerto Rico, see section 7651.

§ 1.1403-1 CROSS REFERENCES.—For provisions relating to the requirement for filing returns with respect to net earnings from self-employment, see § 1.6017-1. For other administrative provisions relating to the tax on self-employment income, see the applicable sections of the regulations in this part (§ 1.6001-1 et seq.) and the applicable sections of the regulations on procedure and administration (Part 301 of this Chapter).

WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS AND TAX-FREE COVENANT BONDS

NONRESIDENT ALIENS AND FOREIGN CORPORATIONS

§ 1.1441 STATUTORY PROVISIONS; WITHHOLDING OF TAX ON NONRESIDENT ALIENS.

SEC. 1441. WITHHOLDING OF TAX ON NONRESIDENT ALIENS.

(a) GENERAL RULE.—Except as otherwise provided in subsection (c), all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, shall (except in the cases provided for in section 1451 and except as otherwise provided in regulations prescribed by the Secretary or his delegate under section 874) deduct and withhold from such items a tax equal to 30 percent thereof.

(b) INCOME ITEMS.—The items of income referred to in subsection (a) are interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, and amounts described in section 402(a)(2), section 631(b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets.

(c) EXCEPTIONS—

(1) DIVIDENDS OF FOREIGN CORPORATIONS.—No deduction or withholding under subsection (a) shall be required in the case of dividends paid by a foreign corporation unless (A) such corporation is engaged in trade or business within the United States, and (B) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under part I of subchapter N of chapter 1.

(2) OWNER UNKNOWN.—The Secretary or his delegate may authorize the tax under subsection (a) to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(3) BONDS WITH EXTENDED MATURITY DATES.—The deduction and withholding in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation, within subsections (a), (b), and (c) of section 1451 were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934, and the liability assumed by the debtor exceeds 27½ percent of the interest, shall not exceed the rate of 27½ percent per annum.

(4) COMPENSATION OF CERTAIN ALIENS.—Under regulations prescribed by the Secretary or his delegate, there may be exempted from deduction and withholding under subsection (a) the compensation for personal services of nonresident alien individuals who enter and leave the United States at frequent intervals.

(5) SPECIAL ITEMS.—In the case of amounts described in section 402(a)(2), section 631(b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets, the amount required to be deducted and withheld shall, if the amount of such gain is not known to the withholding agent, be such amount, not exceeding 30 percent of the proceeds from such sale or exchange, as may be necessary to assure that the tax deducted and withheld shall not be less than 30 percent of such gain.

(d) ALIEN RESIDENT OF PUERTO RICO.—For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

§ 1.1441–1 REQUIREMENT FOR WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—Except as otherwise provided in §§ 1.1441–3 and 1.1441–4, withholding of a tax of 30 percent is required in the case of the items of income specified in § 1.1441–2 (to the extent that such items constitute gross income from sources within the United States) paid to a nonresident alien individual, a nonresident partnership composed in whole or in part of nonresident alien individuals, or a nonresident foreign corporation. The rate of 30 percent shall be reduced as may be provided by treaty with any country. See section 894, relating to income exempt under treaty. For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

§ 1.1441–2 INCOME SUBJECT TO WITHHOLDING.—(a) *Fixed or determinable annual or periodical income.*—(1) The gross amount of fixed or determinable annual or periodical income is subject to withholding. Section 1441 specifically includes in such income interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States), dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments; but other kinds of income are included, as, for instance, royalties. The term "fixed or determinable annual or periodical" income is merely descriptive of the character of a class of income. If an item of income falls within the class of income contemplated by the statute, it is immaterial whether payment of that item is made in a series of repeated payments or in a single lump sum. Thus, $5,000 in royalty income would come within the meaning of the term, whether paid in 10 payments of $500 each or in one payment of $5,000.

(2) Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact

that a payment is not made annually or periodically does not, however, necessarily prevent its being fixed or determinable annual or periodical income. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. The share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently, or which has been paid or credited during the taxable year, to a nonresident alien beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income. Such items as taxes, interest on mortgages, or premiums on insurance paid to or for the account of a nonresident alien landlord by a tenant, pursuant to the terms of the lease, constitute fixed or determinable annual or periodical income.

(3) Income derived from the sale in the United States of property, whether real or personal, is not fixed or determinable annual or periodical income. However, the consideration received from the transfer of property is fixed or determinable annual or periodical income if for purposes of the income tax the consideration is treated as rentals or royalties and not as the proceeds of a sale of property.

(b) *Amounts considered to be gains from the sale or exchange of capital assets.*—Withholding is also required on the gross amount of the items described in section 402(a)(2), relating to treatment of total distributions from certain employees' trusts; section 631(b) and (c), relating to treatment of gain on disposal of timber or coal with a retained economic interest; and section 1235, relating to treatment of gain on sale or exchange of patents, which are considered to be gains from the sale or exchange of capital assets.

§ 1.1441-3 EXCEPTIONS AND RULES OF SPECIAL APPLICATION.—(a) *Income from sources without the United States.*—To the extent that items of income constitute gross income from sources without the United States, they are not subject to withholding under § 1.1441-1. For rules governing the determination of the sources of income, see sections 861 to 864, inclusive, and the regulations thereunder.

(b) *Corporate distributions.*—(1) *Nontaxable portion.*—The tax shall be withheld at the source under § 1.1441-1 on the gross amount of any distribution made by a corporation other than—

(i) A nontaxable distribution payable in stock or stock rights, and

(ii) A distribution which is treated as a distribution in part or full payment in exchange for stock.

This rule shall apply without regard to any claim that all or a portion of the distribution is not taxable under section 871 or 881. The tax shall be withheld on the gross amount of the distribution even though the payee may be entitled to the benefits of section 34, relating to the credit for dividends received by individuals, or section 116, relating to partial exclusion of dividends received by individuals. Appropri-

ate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(2) *Dividends paid by a foreign corporation.*—No withholding under § 1.1441–1 is required in the case of dividends paid by a foreign corporation unless (i) the corporation is engaged in trade or business within the United States, and (ii) more than 85 percent of the gross income of the corporation for the 3-year period ending with the close of its taxable year preceding the declaration of the dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of sections 861–864, inclusive, and the regulations thereunder.

(3) *Dividends paid by a China Trade Act corporation.*—Withholding is required under § 1.1441–1 on dividends paid by a corporation organized under the China Trade Act of 1922 (15 U. S. C., c. 4) if the dividends are treated as income from sources within the United States under sections 861–864, inclusive, and are distributed to—

(i) A nonresident alien other than a resident of Formosa or Hong Kong at the time of the distribution, or

(ii) A nonresident partnership composed in whole or in part of nonresident aliens (other than a partnership resident in Formosa or Hong Kong), or

(iii) A nonresident foreign corporation (other than a corporation resident in Formosa or Hong Kong).

(4) *Dividends paid to shareholder whose status is not definite.*—When a payer corporation or any other person, including a nominee, having the control, receipt, custody, disposal, or payment of dividends has no definite knowledge of the status of a shareholder, the tax shall be withheld under §1.1441–1 if the shareholder's address is outside the United States. If the shareholder's address is within the United States, it may be assumed for the purpose of withholding on dividends that the shareholder is a citizen or resident of the United States. Unless the name and style of the shareholder are such as to indicate clearly that he is a nonresident alien, an address in care of another person in the United States does not of itself warrant treating the shareholder as a nonresident alien for such purpose. If a shareholder changes his address from a place without the United States to a place within the United States, the tax shall be withheld on dividends unless proof is furnished showing that he is a citizen or resident of the United States. For general provisions for claiming United States citizenship or residence, see § 1.1441–5.

(c) *Interest.*—(1) *Government obligations.*—Withholding is required under § 1.1441–1 in the case of interest paid on obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. See section 103 and the regulations thereunder, relating to the taxation of such interest, and § 1.1461–1, relating to ownership certificates.

(2) *Assumed obligations.*—If, in connection with the sale of a corporation's property, payment of the bonds or other obligations of the corporation is assumed by the assignee, the assignee, whether an in-

dividual, partnership, or corporation, shall deduct and withhold such taxes under § 1.1441–1 as would be required to be withheld by the assignor had no such sale or transfer been made.

(3) *Defaulted interest coupons.*—The tax shall be withheld at the source under § 1.1441–1 on the gross amount of interest without regard to whether or not the payment constitutes a return of capital or the payment of income within the meaning of section 61. Thus, for example, the tax shall be withheld in accordance with § 1.1441–1 from defaulted interest payments upon bonds which were purchased flat at quotations representing the price of both the bonds and the defaulted matured interest coupons. Appropriate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(4) *Unknown owner.*—Withholding is required under § 1.1441–1 in the case of interest upon all bonds or securities the owners of which are not known to the withholding agent unless such bonds or securities were issued by a corporation before January 1, 1934, contain a tax-free covenant, and do not have a maturity date which was extended on or after that date. For withholding under section 1451 in the case of unknown owners, see paragraph (a)(2) of § 1.1451–1.

(5) *Tax-free covenant bonds.*—(i) *Issued on or after January 1, 1934.*—Withholding is required under § 1.1441–1 in the case of interest upon bonds or other corporate obligations issued on or after January 1, 1934, and containing a tax-free covenant.

(ii) *Issued before January 1, 1934.*—Withholding is not required under § 1.1441–1 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, containing a tax-free covenant, and not having a maturity date which was extended on or after that date. A domestic or resident fiduciary is required, however, to withhold tax under § 1.1441–1 in the case of so much of such interest as is properly allocable under section 652 or 662 to a nonresident alien beneficiary. See paragraph (f) of this section and of § 1.1451–1. For general rules respecting the withholding of tax under section 1451 in the case of such interest, see § 1.1451–1.

(iii) *Extended maturity date.*—Withholding is required under § 1.1441–1 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant, if the maturity date of the bonds or obligations has been extended on or after that date. See paragraph (c) of § 1.1451–1.

(iv) *Special rate of 27½ percent.*—The rate of tax to be withheld at the source under § 1.1441–1 shall not exceed 27½ percent in the case of interest on bonds, mortgages, or deeds of trust, or other similar obligations of a corporation if—

(*a*) The liability assumed by the debtor exceeds 27½ percent of the interest, and

(*b*) The interest would be subject to withholding under the provisions of subsections (a), (b), and (c) of section 1451 except for the fact that the maturity date of the obligations has been extended on or after January 1, 1934. See paragraph (c) of § 1.1451–1.

(d) *Amounts considered to be gains from the sale or exchange of capital assets.*—(1) If, in the case of the amounts enumerated in paragraph (b) of § 1.1441–2 which are considered to be gains from the sale or exchange of capital assets, the withholding agent does not know the amount of recognized gain, he is required to deduct and withhold such amount under § 1.1441–1 as may be necessary to assure that the tax withheld will not be less than 30 percent of the recognized gain. For this purpose the recognized gain shall be determined without regard to the deduction allowed by section 1202 in respect of capital gains. The amount so withheld shall not exceed 30 percent of the gross proceeds from the transaction giving rise to the recognized gain, except that the gross proceeds may be determined by excluding the net unrealized appreciation described in section 402(a)(2). Appropriate adjustment, if any, will be made upon the payee's filing of a claim for refund, together with appropriate supporting evidence, in accordance with paragraph (h) of this section.

(2) The withholding agent may rely upon the written statement of the person entitled to the income described in this paragraph as to the amount of gain recognized on the transaction involved. This statement shall show the computation of the gain and shall be furnished to the withholding agent in duplicate. The duplicate copy of the statement shall be forwarded with a letter of transmittal to the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such copy shall be forwarded to the Director of International Operations, Internal Revenue Service, Washington 25, D. C.

(e) *Personal exemptions.*—(1) The taxation of nonresident alien individuals is provided for in sections 871 to 877, inclusive. Section 874(a) makes the filing of a return a prerequisite to the allowance of deductions, including deductions of personal exemptions. Except in the circumstances described in subparagraph (2) of this paragraph, personal exemptions do not serve to reduce the amount of tax to be withheld under § 1.1441–1.

(2) In the determination of the tax to be withheld at the source under § 1.1441–1 from remuneration paid for labor or personal services performed within the United States by a nonresident alien, the benefit of the deduction for one personal exemption provided in section 151 shall be allowed, prorated upon a daily basis for the period of employment during any portion of which labor or personal services are performed within the United States by the alien. The proration is on the basis of $1.70 per day. Thus, if A, a nonresident alien seaman employed by X Shipping Corporation, is paid in 1955 upon the termination of a voyage covering 100 days and A performs personal services within the United States during, or incident to, the voyage, the amount of $170 will be allocated as the portion of the deduction to be allowed against the remuneration for personal services performed within the United States during that voyage; and withholding at 30 percent shall be applied against the balance, if any, of the remuneration. If, for example, the total remuneration paid to A for that voyage is $2,000, of which the amount of $800 is allocable to sources within the United States, a tax in the amount of $189 is required to be withheld under § 1.1441–1. As to what constitutes remuneration for labor or personal

services performed within the United States, see section 861(a)(3) and the regulations thereunder.

(f) *Fiduciaries.*—Resident or domestic fiduciaries are required to withhold the tax at source under § 1.1441–1 on all items of income specified in § 1.1441–2 of nonresident alien beneficiaries, to the extent that such items constitute gross income from sources within the United States. Such income paid to a nonresident alien fiduciary is subject to withholding under § 1.1441–1 even though the beneficiaries of the estate or trust are citizens or residents of the United States.

(g) *Trust income taxable to grantor.*—The income of a trust created by a nonresident alien individual and taxable to the grantor under the provisions of subpart E of part I of subchapter J is subject to withholding under § 1.1441–1, even though the fiduciary or beneficiaries of the trust are citizens or residents of the United States and regardless of whether the beneficiaries are exempt from income tax.

(h) *Claims for refund.*—Notwithstanding § 301.6402–2 of this Chapter, any claim for refund referred to in paragraphs (b), (c), and (d) of this section which is filed on and after January 1, 1957, shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C. For special rules permitting the use of the income tax return as a claim for refund, see § 301.6402–3 of this Chapter.

(i) *Rents paid to foreign tax-exempt organizations.*—For the rule for withholding on rents paid to foreign tax-exempt organizations, see § 1.1443–1.

§ 1.1441–4 Exemptions From Withholding.—(a) *Interest.*—(1) *Interest on bank deposits.*—Interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States is not subject to withholding under § 1.1441–1.

(2) *Sale of bonds between interest dates.*—The tax is not required to be withheld under § 1.1441–1 on accrued interest paid by the buyer in connection with the sale of bonds between interest dates, even though the interest is subject to tax under section 871 or 881. The exemption from withholding granted by this subparagraph is not a determination that the accrued interest is not fixed or determinable annual or periodical income.

(b) *Compensation for personal services.*—(1) *Exemption under section 1441.*—The salary or other compensation for personal services of a nonresident alien individual who enters and leaves the United States at frequent intervals shall not be subject to withholding of tax under § 1.1441–1 if—

(i) The nonresident alien is a resident of Canada or Mexico, or

(ii) The nonresident alien is engaged in agricultural labor as defined in section 3121(g) and the regulations thereunder.

(2) *Withholding of tax under section 3402.*—For collection of the income tax at source under section 3402 upon remuneration paid for services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the United States at frequent intervals, see section 3401(a)(7) and the regulations thereunder.

(3) *Proration of personal exemption.*—For provisions allowing the benefit of the deduction for the personal exemption on a prorated basis, see paragraph (e) of § 1.1441–3.

(c) *Dividends paid by China Trade Act corporations.*—Withholding is not required under § 1.1441–1 upon dividends distributed by a corporation organized under the China Trade Act of 1922 (15 U. S. C., c. 4) to or for the benefit of a resident of Formosa or Hong Kong and which are exempt from taxation by section 943.

(d) *Inhabitants of Virgin Islands.*—(1) *Allowance of exemption.*—No withholding is required under § 1.1441–1 upon any item of income paid to any person who at the time of payment reasonably expects to satisfy his income tax obligations with respect to that item under section 28(a) of the Revised Organic Act of the Virgin Islands. That section provides that all persons whose permanent residence is in the Virgin Islands "shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the Treasury of the Virgin Islands." For the purpose of this paragraph, the term "person" shall include an individual, partnership, and corporation.

(2) *Claiming exemption.*—To avoid withholding of tax at source under § 1.1441–1 the payee of the income shall notify the withholding agent by letter in duplicate that he expects to satisfy his income tax obligations under section 28(a) of the Revised Organic Act of the Virgin Islands with respect to all income to be paid to him by the withholding agent during the current calendar year. This letter of notification shall constitute authorization to the payer of the income to pay income to the payee during that year without deduction of the tax at source under § 1.1441–1.

(3) *Disposition of letter.*—The duplicate copy of each letter of notification shall be forwarded with a letter of transmittal to the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such copy shall be forwarded to the Director of International Operations, Internal Revenue Service, Washington 25, D. C.

§ 1.1441–5 Claiming United States Citizenship or Residence.—(a) *Individuals.*—For purposes of chapter 3 an individual's written statement that he is a citizen or resident of the United States may be relied upon by the payer of the income as proof that such individual is a citizen or resident of the United States. This statement shall be furnished to the withholding agent in duplicate. An alien may claim residence in the United States by filing Form 1078 with the withholding agent in duplicate in lieu of the above statement.

(b) *Partnerships and corporations.*—For purposes of chapter 3 a written statement from a partnership or corporation claiming residence in the United States may be relied upon by the payer of the income as proof that such partnership or corporation is a resident of the United States. This statement shall be furnished to the withholding agent in duplicate. It shall contain the address of the taxpayer's office or place of business in the United States and shall be signed by a member of the partnership or by an officer of the corporation. The official title of the corporate officer shall also be given.

(c) *Manner of filing statement or form.*—(1) The statement of citizenship or residence, or Form 1078 in the case of residence, shall be filed with the withholding agent for each successive three-calendar-year period during which the income is paid in respect of which the statement or form is furnished. The statement or form shall be filed with the withholding agent not later than 20 days preceding the date of the first payment within the three-calendar-year period for which the statement or form is furnished, or, if that is not possible because of special circumstances, as soon as possible after such first payment.

(2) Once a statement or form has been filed in respect of any three-calendar-year period, no additional statement or form is required to be filed in respect thereto unless the Commissioner of Internal Revenue notifies the withholding agent that an additional statement or form shall be filed by the taxpayer. If, after filing a statement or form, the taxpayer ceases to be a citizen or resident of the United States, he shall promptly notify the withholding agent.

(3) Upon the expiration of any three-calendar-year period, the statement or form filed in respect of that period may not be relied upon by the payer of the income as proof of citizenship or residence.

(d) *Disposition of statement and form.*—The duplicate copy of each statement and form filed pursuant to this section shall be forwarded with a letter of transmittal to the Director of International Operations, Internal Revenue Service, Washington 25, D. C.

(e) *Definitions.*—As to who are nonresident alien individuals, see sections 871, 7701, and the regulations thereunder. As to what partnerships and corporations are deemed to be nonresident, see sections 881, 882, 7701, and the regulations thereunder.

(f) *Effective date.*—This section shall apply with respect to payments made after December 31, 1956. The provisions of §§ 39.143–3 (a) and 39.144–2 of Regulations 118 (26 CFR (1953 Rev. Part 39) corresponding to the provisions of this section, which were made applicable to chapter 3 of the 1954 Code by Treasury Decision 6091, 19 F. R. 5167, shall be deemed to apply under such chapter with respect to all payments made after December 31, 1954, and before January 1, 1957.

§ 1.1442 Statutory Provisions; Withholding of Tax on Foreign Corporations.

SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.

In the case of foreign corporations subject to taxation under this subtitle not engaged in trade or business within the United States, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein.

§ 1.1442–1 Withholding of Tax on Foreign Corporations.—For regulations respecting the withholding of tax at source under section 1442 in the case of nonresident foreign corporations, see §§ 1.1441–1 and 1.1451–1.

§ 1.1443 Statutory Provisions; Foreign Tax-Exempt Organizations.

SEC. 1443. FOREIGN TAX-EXEMPT ORGANIZATIONS.

In the case of income of a foreign organization subject to the tax imposed by section 511, this chapter shall apply to rents includible under section 512 in computing its unrelated business taxable income, but only to the extent and subject to such conditions as may be provided under regulations prescribed by the Secretary or his delegate.

§ 1.1443–1 Rents Paid to Foreign Tax-Exempt Organizations.—The gross amount of rents paid to a foreign organization subject to the tax imposed by section 511, which are includible under section 512 in computing its unrelated business taxable income, is subject to withholding of a tax of 30 percent in the manner prescribed for withholding of the tax under § 1.1441–1, even though the organization is engaged in trade or business within the United States.

Tax-Free Covenant Bonds

§ 1.1451 Statutory Provisions; Tax-Free Covenant Bonds.

SEC. 1451. TAX-FREE COVENANT BONDS.

(a) Requirement of Withholding.—In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, issued before January 1, 1934, contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this subtitle on the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 percent (regardless of whether the liability assumed by the obligor is less than, equal to, or greater than 2 percent) of the interest on such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to—

(1) an individual,

(2) a partnership, or

(3) a foreign corporation not engaged in trade or business within the United States.

(b) Payments to Foreigners.—Notwithstanding subsection (a), if the liability assumed by the obligor does not exceed 2 percent of the interest, then the deduction and withholding shall be at the rate of 30 percent in the case of—

(1) a nonresident alien individual,

(2) any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, and

(3) a foreign corporation not engaged in trade or business within the United States.

(c) Owner Unknown.—If the owners of such obligations are not known to the withholding agent, the Secretary or his delegate may authorize such deduction and withholding to be at the rate of 2 percent, or, if the liability assumed by the obligor does not exceed 2 percent of the interest, then at the rate of 30 percent.

(d) Benefit of Personal Exemptions.—Deduction and withholding under this section shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the deduction for personal exemptions provided in section 151; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Secretary or his delegate under section 874.

(e) Alien Residents of Puerto Rico.—For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(f) INCOME OF OBLIGOR AND OBLIGEE.—The obligor shall not be allowed a deduction for the payment of the tax imposed by this subtitle, or any other tax paid pursuant to the tax-free covenant clause, nor shall such tax be included in the gross income of the obligee.

§ 1.1451-1 TAX-FREE COVENANT BONDS ISSUED BEFORE JANUARY 1, 1934.—(a) *Rates of withholding.*—(1) *Rate of 2 percent.*—Withholding of a tax equal to 2 percent is required in the case of interest upon bonds or other corporate obligations containing a tax-free covenant and issued before January 1, 1934, paid to an individual, a fiduciary, or a partnership, whether resident or nonresident, or to a nonresident foreign corporation, regardless of whether the liability assumed by the obligor is less than, equal to, or greater than 2 percent.

(2) *Rate of 30 percent.*—Notwithstanding subparagraph (1) of this paragraph, if the liability assumed by the obligor does not exceed 2 percent of the interest, withholding is required at the rate of 30 percent in the case of payments to a nonresident alien individual, a nonresident partnership composed in whole or in part of nonresident aliens, a nonresident foreign corporation, or an owner who is unknown to the withholding agent.

(3) *Obligations of resident payers.*—The rates of withholding specified in subparagraphs (1) and (2) of this paragraph are applicable to interest on such tax-free covenant bonds issued by a domestic corporation or by a resident foreign corporation.

(4) *Obligations of nonresident payers.*—A nonresident foreign corporation having a fiscal or paying agent in the United States is required to withhold a tax of 2 percent in the case of interest upon its tax-free covenant bonds issued before January 1, 1934, which is paid to an individual or fiduciary who is a citizen or resident of the United States, to a partnership any member of which is a citizen or resident, or to an unknown owner.

(5) *Interest from sources without the United States.*—Withholding is not required under section 1451 in the case of interest upon bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant if the interest is not to be treated as income from sources within the United States and the payments are made to a nonresident alien, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation.

(6) *Tax treaties.*—The rates of tax to be withheld in accordance with this paragraph shall be reduced as may be provided by treaty with any country. See section 894, relating to income exempt under treaty.

(b) *Date of issue.*—The withholding provisions of section 1451 are applicable only to bonds, mortgages, or deeds of trust, or other similar obligations of a corporation which were issued before January 1, 1934, and which contain a tax-free covenant. For the purpose of section 1451, bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, are issued when delivered. If a broker or other person acts as selling agent of the obligor, the obligation is issued when delivered by the agent to the purchaser. If a broker or other person purchases the obligation outright for the purpose of holding

or reselling it, the obligation is issued when delivered to such broker or other person.

(c) *Extended maturity date.*—In cases where on or after January 1, 1934, the maturity date of bonds or other obligations of a corporation is extended, the bonds or other obligations shall be considered to have been issued on or after January 1, 1934. The interest on such obligations is not subject to the withholding provisions of section 1451 but falls within the class of interest described in section 1441. See paragraph (c)(5)(iii) of § 1.1441–3.

(d) *Covenant in trust deed.*—Bonds issued under a trust deed containing a tax-free covenant are treated as if they contain such a covenant. If neither the bonds nor the trust deeds given by the obligor to secure them contained a tax-free covenant, but the original trust deeds were modified before January 1, 1934, by supplemental agreements containing a tax-free covenant executed by the obligor corporation and the trustee, the bonds issued before January 1, 1934, are subject to the provisions of section 1451, provided appropriate authority existed for the modification of the trust deeds in this manner. The authority must have been contained in the original trust deeds or actually secured from the bondholders.

(e) *Notation showing date of issue.*—In order that the date of issue of bonds, mortgages, deeds of trust, or other similar corporate obligations containing a tax-free covenant may be readily determined by the owner for the purpose of preparing the ownership certificates required by § 1.1461–1, the issuing or debtor corporation shall indicate the date of issue by an appropriate notation, or use the phrase "issued on or after January 1, 1934," on each such obligation or in a statement accompanying the delivery of the obligation.

(f) *Effect of withholding on income taxes of bondholder and issuing corporation.*—(1) *Federal tax.*—In the case of corporate bonds or other corporate obligations issued before January 1, 1934, and containing a tax-free covenant, the corporation paying a Federal tax, or any part of it, for someone else pursuant to its agreement is not entitled to deduct such payment from its gross income on any ground; nor shall the tax so paid be included in the gross income of the bondholder. The amount of the tax so paid may, nevertheless, be claimed by the bondholder in accordance with paragraph (a) of § 1.1462–1 as a credit against the total amount of income tax due. See also section 32. The tax so paid by the corporation upon tax-free covenant bond interest payable to a domestic or resident fiduciary and allocable to any nonresident alien beneficiary under section 652 or 662 is allowable, pro rata, as a credit against—

(i) The tax required to be withheld by the fiduciary in accordance with paragraph (f) of § 1.1441–3 from the income of the beneficiary, and

(ii) The total income tax computed in the return of the beneficiary, as indicated in paragraph (a) of § 1.1462–1.

(2) *State taxes.*—In the case of corporate bonds or other obligations containing an appropriate tax-free covenant, the corporation paying for someone else, pursuant to its agreement, a State tax or

any tax other than a Federal tax may deduct such payment as interest paid on indebtedness.

(g) *Alien resident of Puerto Rico.*—For purposes of this section the term "nonresident alien individual" includes an alien resident of Puerto Rico.

(h) *Other rules for withholding of tax under section 1451.*—The rules for withholding stated in paragraphs (c) (2) and (3), (f), and (g) of § 1.1441–3 shall also apply for purposes of withholding the tax under this section.

§ 1.1451–2 Exemptions From Withholding Under Section 1451.—(a) *Claiming personal exemptions.*—Withholding under § 1.1451–1 from interest on bonds or other obligations of corporations issued before January 1, 1934, and containing a tax-free covenant shall not be required if there is filed with the withholding agent when presenting coupons for payment, or not later than February 1 of the following year, an ownership certificate on Form 1000 stating—

(1) In the case of a citizen or resident of the United States, that his taxable income does not exceed his deductions for personal exemptions allowed under section 151; or

(2) In the case of an estate or trust the fiduciary of which is a citizen or resident of the United States, that its taxable income does not exceed the deduction for the personal exemption allowed under section 642(b).

(b) *Claiming residence in United States.*—To claim residence in the United States for purposes of section 1451, see § 1.1441–5.

(c) *Other exemptions.*—The exemptions allowed by paragraphs (a) (2) and (d) of § 1.1441–4 shall also apply for purposes of section 1451.

Application of Withholding Provisions

§ 1.1461 Statutory Provisions; Return and Payment of Withheld Tax.

SEC. 1461. RETURN AND PAYMENT OF WITHHELD TAX.

Every person required to deduct and withhold any tax under this chapter shall, on or before March 15 of each year, make return thereof and pay the tax to the officer designated in section 6151. Every such person is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter.

§ 1.1461–1 Ownership Certificates for Bond Interest.—(a) *Citizens and residents of the United States.*—In accordance with section 6041, citizens, resident individuals, fiduciaries, and partnerships, and nonresident partnerships all of the members of which are citizens or residents, owning bonds, mortgages, or deeds of trust, or other similar obligations issued by a domestic corporation, a resident foreign corporation, or a nonresident foreign corporation having a fiscal or paying agent in the United States, shall, when presenting interest coupons for payment, file ownership certificates for each issue of such obligations issued before January 1, 1934, and containing a tax-free covenant. This rule shall apply without regard to the amount of the interest coupons.

(b) *Nonresident aliens and foreign corporations.*—(1) In accordance with section 6041, nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident aliens, nonresident foreign corporations, and unknown owners, owning bonds, mortgages, or deeds of trust, or other similar obligations of a corporation, shall, when presenting interest coupons for payment, file ownership certificates for each issue of all such obligations whether or not the obligation contains a tax-free covenant. This rule shall apply without regard to the amount of the interest coupons and without regard to the date on which the obligations were issued.

(2) Ownership certificates are not required to be filed, however, by a nonresident alien individual, a partnership composed wholly of nonresident aliens, or a nonresident foreign corporation in connection with interest payments on bonds, mortgages, or deeds of trust, or other similar obligations of a nonresident foreign corporation or of any domestic or foreign corporation which qualifies under section 861(a)(1)(B) (relating to interest from payers deriving substantially all their income from sources without the United States).

(3) Ownership certificates shall also be filed in the case of interest paid on obligations of the United States or of any agency or instrumentality thereof, irrespective of the date on which the obligations are issued or of the amount of the interest, if the obligations are owned by a nonresident alien individual, nonresident partnership composed in whole or in part of nonresident aliens, nonresident foreign corporations, or an unknown owner.

(c) *Overdue coupon bonds.*—In the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates are required to be filed when collecting the interest in the same manner as if interest coupons were presented for collection.

(d) *Information shown on ownership certificate.*—The ownership certificate shall show the name and address of the obligor, the name and address of the owner of the obligations, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be withheld, and the date upon which the interest coupons were presented for payment. In the case of ownership certificates filed with the withholding agent on and after January 1, 1957, the certificates shall also show the amount of tax, if any, withheld; or, if the certificate has been used under a tax treaty regulation to claim a release of tax withheld, then it shall show both the amount of tax withheld and also the amount of tax released. On and after January 1, 1957, this paragraph shall apply to all special variations of Form 1001 referred to in paragraph (i) of this section.

(e) *Ownership certificates not required.*—Ownership certificates are not required to be filed in the case of interest payments on—

(1) Obligations of a State, Territory, or possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

(2) Bonds, mortgages, or deeds of trust, or other similar obligations issued by an individual or a partnership; and

(3) Obligations owned by a domestic corporation, resident foreign corporation, or foreign government.

(f) *Interest coupons unaccompanied by ownership certificates.*—(1) When interest coupons detached from corporate bonds, or from obligations of the United States or of any agency or instrumentality thereof, are received unaccompanied by ownership certificates, the first bank to which the coupons are presented for payment shall require of the payee a statement showing the name and address of the person from whom the coupons were received by the payee and alleging that the owner of the bonds is unknown to the payee. This rule shall not apply if the owner of the bonds is known to the bank and the bank is satisfied that the owner is a person who is not required to file an ownership certificate.

(2) The bank shall also require the payee to prepare an ownership certificate on Form 1001, which shall be modified by crossing out "owner," inserting "payee," stamping or writing across the face of the certificate "Statement furnished," and adding the name of the bank.

(3) The statement furnished pursuant to this paragraph shall be forwarded to the District Director of Internal Revenue, Baltimore 2, Maryland, with the quarterly return on Form 1012; except that on and after January 1, 1957, such statement shall be forwarded to the Director of International Operations, Internal Revenue Service, Washington 25, D. C., with the annual return on Form 1042.

(g) *Noncoupon bonds.*—(1) *General rule.*—Ownership certificates on Form 1000 or Form 1001 are required in connection with interest payments on noncoupon bonds as in the case of coupon bonds. If an ownership certificate is not furnished by the owner of a noncoupon bond, the certificate shall be prepared by the withholding agent but is not required to be signed by the owner.

(2) *Application of tax treaties.*—Ownership certificates are not required, however, when claiming the benefit of an exemption from tax, or reduced rate of tax, granted by an applicable tax convention in respect of interest payments on noncoupon bonds. Regulations under the various income tax conventions require, in lieu of an ownership certificate, the use of an exemption (or reduced rate) certificate (or corresponding letter) in the case of such interest payments. Such a certificate may not be prepared by the withholding agent but must be signed by the owner of the interest, or by his trustee or agent, in accordance with the applicable tax treaty regulation.

(h) *Form of ownership certificate for citizens and residents.*—Form 1000 shall be used in preparing ownership certificates of individuals or fiduciaries who are citizens or residents of the United States, of resident partnerships, and of nonresident partnerships all of the members of which are citizens or residents. If the obligations are issued by a nonresident foreign corporation having a fiscal or paying agent in the United States, Form 1000 shall be modified to show the name and address of the fiscal agent or the paying agent in addition to the name and address of the debtor corporation. Duplicate copies of Form 1000 are not required.

(i) *Form of ownership certificate for nonresident aliens and foreign corporations.*—Form 1001 shall be used in preparing ownership certificates of nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident aliens, nonresident for-

eign corporations, and unknown owners. A special variation of Form 1001 (designated by a letter or letters following the number 1001) shall be used, however, in preparing ownership certificates of persons claiming the benefit of an exemption from tax, or reduced rate of tax, granted by an applicable income tax convention in respect of interest payments on coupon bonds. See the applicable tax treaty regulation and paragraph (d) of this section. In the case of payments of interest made before January 1, 1957, duplicate copies of Form 1001 are not required; on and after that date Form 1001 shall be filed in duplicate whenever the form is required by this section. The special variations of Form 1001 shall be filed in duplicate, as required by the applicable tax treaty regulation.

(j) *Ownership certificates in the case of fiduciaries and joint owners.*—(1) Fiduciaries having the control and custody of more than one estate or trust, the assets of which include bonds of corporations and other securities, shall execute a certificate of ownership for each estate or trust even though the bonds are of the same issue. The ownership certificate shall show both the name of the estate or trust and the name and address of the fiduciary.

(2) Separate ownership certificates shall be executed in behalf of each person owning bonds jointly with another.

(k) *Inconsistent regulations.*—All regulations inconsistent with the provisions of this section shall be deemed to have been modified accordingly.

§ 1.1461–2 RETURN AND PAYMENT OF TAX WITHHELD ON AND AFTER JANUARY 1, 1957.—(a) *Effective date.*—This section shall apply only with respect to payments of income made on and after January 1, 1957. For provisions relating to payments made before that date, see § 1.1461–3.

(b) *Form 1042.*—(1) *Filing requirements.*—Every withholding agent shall make on or before March 15 an annual return on Form 1042 of the tax withheld under chapter 3 upon all the items of income to which that chapter applies. Form 1042 shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C. The return shall be prepared in duplicate and shall show in summary form the tax required to be withheld under chapter 3 during the previous calendar year and to be shown on Forms 1000, 1001, and 1042S, and on all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1. The duplicate copy of Form 1042 shall be retained by the withholding agent.

(2) *Summary of accompanying forms.*—Form 1042 shall be accompanied by the original copies of all Forms 1000 and by the original and duplicate copies of all Forms 1001, 1042S, and all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1, which were filed with, or prepared by, the withholding agent during the previous calendar year, including such forms upon which income exempt from withholding of tax is reported. The various forms so forwarded with Form 1042 are not required to be listed thereon; but they shall be summarized on Form 1042 by showing in the manner prescribed thereon and in the instructions applicable thereto, the total number of each form submitted and, with respect to that particular form, the gross amount of income paid and the rates of tax applicable thereto, the total

amount of income paid which was exempt from withholding of tax, the amount of tax withheld at the various applicable rates, and the amount of tax withheld but released or refunded by the withholding agent. The information so given with respect to Form 1042S shall be arranged on a per-country basis as to payees with addresses in the various foreign countries which have entered into an income tax convention with the United States and on a combined basis as to payees with addresses in all other countries. This per-country arrangement is not required in the case of the other forms forwarded with Form 1042. The exemption and reduced rate certificates, such as Form 1001A–D or Form 1001A–J, referred to in paragraph (g)(2) of § 1.1461–1 are not required to accompany, or to be summarized on, Form 1042.

(3) *Manner of preparing ownership certificates.*—To facilitate compliance with subparagraph (2) of this paragraph the ownership certificates (Form 1000, Form 1001, and all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1) prepared by any withholding agent for forwarding with Form 1042 shall be prepared and arranged in accordance with the instructions applicable thereto and consistently with the manner prescribed by paragraph (c)(3)(ii) of this section with respect to Form 1042S.

(4) *Modification of Form 1042.*—If Form 1000 is modified in accordance with paragraph (h) of § 1.1461–1 to show the name and address of a fiscal or paying agent in the United States, Form 1042 shall be likewise modified.

(c) *Form 1042S.*—(1) *Filing requirement.*—Every withholding agent shall make on or before March 15 an annual information return on Form 1042S of all items of income specified in §1.1441–2 (to the extent that such items constitute gross income from sources within the United States) paid during the previous calendar year to nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident alien individuals, and nonresident foreign corporations, including such items of income upon which, under the authority of any Treasury regulation or ruling of the Commissioner of Internal Revenue, no withholding of tax is required under chapter 3 or in respect of which the tax, though required to be withheld under such chapter, has, pursuant to such authority, been released or refunded to the payee. Income paid to such persons and required to be shown on Form W–2, Form 1001, or on any special variation of Form 1001 referred to in paragraph (i) of § 1.1461–1, or the substitute thereof, is not, however, required to be shown on Form 1042S. The original and duplicate copies of Form 1042S shall accompany Form 1042 and shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C.

(2) *Information to be furnished.*—(i) Form 1042S shall show the name and address of the payee of the income, of the withholding agent, of the agent for the withholding agent, and of the payer of the income if the payer is not the same as the withholding agent. It shall also show the nature of the item of income paid, the gross amount of the item, and, if withholding upon that item is required under chapter 3, the rate of tax applicable thereto and the amount of tax withheld. If any part of the tax required to be withheld has been

released or refunded to the payee, Form 1042S shall show the amount of tax so released or refunded.

(ii) If a Form 1042S is prepared in respect of an item of income upon which tax has not been withheld under chapter 3, a brief statement as to the authority for such failure to withhold shall be made upon the form itself. If necessary, however, a separate statement as to such authority may be attached to the original copy of the Form 1042S.

(iii) If a Form 1042S is prepared in respect of compensation from which the personal exemption is deducted in accordance with paragraph (e) of § 1.1441–3, the amount of the compensation allocable to labor or personal services performed within the United States, together with the amount of the deduction for the prorated personal exemption, shall be shown on a separate statement attached to the original copy of that form.

(3) *Manner of preparing Form 1042S.*—(i) Form 1042S shall be prepared in quadruplicate with respect to each separate payment of any item of income made during the calendar year, except that, at the option of the withholding agent, one form may be used to show the total amount of any item paid during the calendar year to the same payee. Items different in kind may not be combined on one Form 1042S. Thus, if three dividends on the same stock are paid to the same payee during the calendar year, the three payments may be entered on three separate Forms 1042S or in total amount on one Form 1042S. On the other hand, a payment of interest, dividends, and rents may not be shown on the same Form 1042S. Payment of an item of income to a nominee or representative for the benefit of other persons in respect of whom Forms 1042S are required may not be shown on a single Form 1042S but must be identified with the ultimate recipients of the income if such information is known to the payer of the income.

(ii) The Forms 1042S prepared by any withholding agent for forwarding with Form 1042 shall be segregated as to payees with addresses in foreign countries which have entered into an income tax convention with the United States and as to payees with addresses in all other countries. The first such group shall be arranged alphabetically both as to the name of the payee and the name of the foreign country in which the payee has an address; the second such group shall be arranged alphabetically as to the name of the payee only. Separate adding machine tapes shall then be prepared for each such foreign country which has entered into an income tax convention with the United States, showing as to that country the number of such forms submitted, the total amount of income paid which was exempt from withholding of tax, and, as to each separate applicable rate of tax, the gross amount of income paid and the amount of tax withheld. Another adding machine tape showing the same information shall then be prepared with respect to the combined number of all other countries. These adding machine tapes shall be properly identified with the respective groups of forms to which they apply, and the totals thereon used as a basis for making the summary on Form 1042 prescribed by paragraph (b)(2) of this section. If circumstances warrant, the withholding agent may use any other appropriate method,

in lieu of adding machine tapes, for presenting the information required by this subdivision.

(iii) The triplicate copy of Form 1042S shall be furnished to the payee indicated thereon, and the quadruplicate shall be retained by the withholding agent.

(4) *Alternative methods.*—To the extent that the withholding agent's system of record keeping makes impractical the use of Form 1042S in the manner prescribed by subparagraph (3) of this paragraph, he may devise and submit for the prior approval of the Commissioner a variation of Form 1042S which will include the information required by subparagraph (2) of this paragraph and which will substantially comply with the requirements of subparagraph (3) of this paragraph. Request for such approval shall be accompanied by an explanation as to why such variation is necessary.

(d) *Information to be furnished by Commissioner.*—If a foreign country has entered into an income tax convention with the United States which provides for the mutual exchange of information, the Commissioner of Internal Revenue shall, as soon as practicable after the close of a calendar year during which the convention is in effect, transmit to the appropriate authority designated in the convention with that country the following forms which have been filed pursuant to this section for that year, namely, all duplicate copies of Forms 1001 and 1042S showing a payee with an address in that country and all duplicate copies of the special variation of Form 1001 referred to in paragraph (i) of § 1.1461–1 which is applicable to that country. These forms are not to be furnished to any such foreign country, however, if the Commissioner of Internal Revenue ascertains through appropriate channels that the forms are not required by that country.

(e) *Date of payment; penalties.*—The tax required to be returned on Form 1042 shall be paid to the Director of International Operations, Internal Revenue Service, Washington 25, D. C., on or before March 15 of the following year. For penalties and additions to the tax attaching upon failure to make returns or such payments, see sections 6651, 6653, 7202, and 7203.

(f) *Special items.*—The tax withheld in accordance with paragraphs (b) (1), (c) (3), and (d) (1) of § 1.1441–3 shall be returned and paid in accordance with this section even though the items involved may not constitute gross income in whole or in part. For such purpose, a reference in this section to an item or amount of income shall, where appropriate, be deemed to refer also to the items specified in such paragraphs or the amount thereof.

(g) *Inconsistent regulations.*—All regulations inconsistent with the provisions of this section shall be deemed to have been modified accordingly.

§ 1.1461–3 RETURN AND PAYMENT OF TAX WITHHELD BEFORE JANUARY 1, 1957.—(a) *Effective date.*—This section shall apply only with respect to payments of income made before January 1, 1957. For provisions relating to payments made on and after that date, see § 1.1461–2.

(b) *Interest on certain bonds.*—(1) *Form 1013.*—Every withholding agent shall make on or before March 15 an annual return on Form 1013 of the tax withheld under chapter 3 from interest (other than in-

terest on noncoupon bonds with respect to which a reduced rate certificate (or corresponding letter) has been filed with the withholding agent in accordance with regulations under a tax convention) on (i) bonds or other obligations of corporations and (ii) obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. This return shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such return shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C.

(2) *Form 1012.*—The withholding agent also shall make and file with the District Director of Internal Revenue, Baltimore 2, Maryland, a quarterly return on Form 1012 of the tax so withheld from such interest, on or before the last day of the month following the termination of the quarter for which the return is made. On and after January 1, 1957, however, the quarterly return on Form 1012 shall be made and filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C. The ownership certificates (Form 1000, Form 1001, and all special variations of Form 1001 referred to in paragraph (i) of § 1.1461–1) shall be forwarded with the quarterly return, even though the interest in respect of which the certificate is filed is exempt from withholding of tax. Forms 1001 shall be listed on the quarterly return. All special variations of Form 1001 (referred to in paragraph (i) of § 1.1461–1) which have been used to secure a reduction in the rate of tax withheld at source shall also be listed on the quarterly return. While Forms 1000 need not be listed on the return, the number of such forms submitted, the total amount of interest paid, and the total amount of the tax required to be withheld in respect of such forms shall be entered in the spaces provided on Form 1012.

(3) *Modification of Forms 1012 and 1013.*—If Form 1000 is modified in accordance with paragraph (h) of § 1.1461–1 to show the name and address of a fiscal or paying agent in the United States, Forms 1012 and 1013 shall be likewise modified.

(c) *Payments other than interest on certain bonds.*—(1) *Form 1042.*—Every withholding agent shall make on or before March 15 an annual return on Form 1042 of the tax withheld under chapter 3 from income other than bond interest in respect of which the tax is required to be reported on Form 1012. This return shall be filed with the District Director of Internal Revenue, Baltimore 2, Maryland; except that on and after January 1, 1957, such return shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C. The return shall show the amount of tax required to be withheld from each nonresident alien, nonresident partnership composed in whole or in part of nonresident aliens, and nonresident foreign corporation, to which income other than such bond interest was paid during the previous calendar year.

(2) *Income exempt from tax.*—The withholding agent shall also report on Form 1042—

(i) All such items of income, otherwise required to be returned thereon pursuant to subparagraph (1) of this paragraph, upon which the tax has not been withheld at source because of an income

tax convention which is in effect between the United States and a foreign country, and

(ii) Interest paid to such persons on noncoupon bonds with respect to which an exemption certificate (or corresponding letter) has been filed with the withholding agent in accordance with regulations under a tax convention.

(3) *Proration of personal exemption.*—In a case where the personal exemption is prorated in accordance with paragraph (e) of § 1.1441–3 the amount of the compensation allocable to labor or personal services performed within the United States, together with the amount of the deduction for the prorated personal exemption, shall be shown on a separate statement attached to the annual return on Form 1042.

(d) *Date of payment; penalties.*—The tax required to be returned on Forms 1012, 1013, and 1042 shall be paid to the district director on or before March 15 of the following year; except that on and after January 1, 1957, such tax shall be paid to the Director of International Operations, Internal Revenue Service, Washington 25, D. C. For penalties and additions to the tax attaching upon failure to make returns or such payments, see sections 6651, 6653, 7202, and 7203.

(e) *Information returns.*—For the extent to which ownership certificates and returns filed by withholding agents will constitute, and be treated as, returns of information required by section 6041, see the regulations issued pursuant to that section.

(f) *Special items.*—The tax withheld in accordance with paragraphs (b) (1), (c) (3), and (d) (1) of § 1.1441–3 shall be returned and paid in accordance with this section even though the items involved may not constitute gross income in whole or in part. For such purpose, a reference in this section to an item or amount of income shall, where appropriate, be deemed to refer also to the items specified in such paragraphs or the amount thereof.

§ 1.1462 Statutory Provisions; Withheld Tax as Credit to Recipient of Income.

SEC. 1462. WITHHELD TAX AS CREDIT TO RECIPIENT OF INCOME.

Income on which any tax is required to be withheld at the source under this chapter shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

§ 1.1462–1 Withheld Tax as Credit to Recipient of Income.—(a) *Return of income from which tax was withheld.*—The entire amount of the income from which the tax is required to be withheld shall be included in gross income in the return required to be made by the recipient of the income, without deduction for the amount required to be withheld, but the tax so withheld shall be allowed as a credit against the total income tax computed in the taxpayer's return.

(b) *Amounts paid to fiduciaries.*—Tax withheld at the source under chapter 3 upon income paid to any fiduciary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. Thus, for example, if any taxpayer is subject to the taxes imposed by section 1, 2, 3, or 11 upon any portion of the income of a nonresident alien estate or trust, the part of any tax withheld at the source which

is properly allocable to the income so taxed to such taxpayer shall be credited against the amount of the income tax computed upon his return, and any excess shall be credited against any income, war profits, or excess profits tax, or installment thereof, then due from the taxpayer, and any balance shall be refunded.

§ 1.1463 Statutory Provisions; Tax Paid by Recipient of Income.

SEC. 1463. TAX PAID BY RECIPIENT OF INCOME.

If any tax required under this chapter to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed on or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

§ 1.1463–1 Tax Paid by Recipient of Income.—If the tax required to be withheld under chapter 3 is paid by the recipient of the income or by the withholding agent, it shall not be re-collected from the other, regardless of the original liability therefor; and, in such event, no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved.

§ 1.1464 Statutory Provisions; Refunds and Credits With Respect to Withheld Tax.

SEC. 1464. REFUNDS AND CREDITS WITH RESPECT TO WITHHELD TAX.

Where there has been an overpayment of tax under this chapter, any refund or credit made under chapter 65 shall be made to the withholding agent unless the amount of such tax was actually withheld by the withholding agent.

[Section 6414, which is contained in chapter 65, provides as follows: "In the case of an overpayment of tax imposed by chapter 24, or by chapter 3, refund or credit shall be made to the employer or to the withholding agent, as the case may be, only to the extent that the amount of such overpayment was not deducted and withheld by the employer or withholding agent."]

§ 1.1464–1 Refunds and Credits.—The refund or credit under chapter 65 of an overpayment of tax which has actually been withheld at the source under chapter 3 shall be made to the taxpayer from whose income the amount of such tax was in fact withheld. To the extent that the overpayment under chapter 3 was not in fact withheld at the source, but was paid, by the withholding agent, the refund or credit under chapter 65 of the overpayment shall be made to the withholding agent. Thus, where a debtor corporation assumes liability pursuant to its tax-free covenant for the tax required to be withheld under chapter 3 upon interest and pays the tax in behalf of its bondholder, and it can be shown that the bondholder is not in fact liable for any tax, the overpayment of tax shall be credited or refunded to the withholding agent in accordance with chapter 65 since the tax was not actually deducted and withheld from the interest paid to the bondholder. In further illustration, where a withholding agent who is required by chapter 3 to withhold $300 tax from rents paid to a nonresident alien individual mistakenly withholds $320 and mistakenly pays $350 as internal revenue tax, the amount of $30 shall be credited

or refunded to the withholding agent in accordance with chapter 65 and the amount of $20 shall be credited or refunded in accordance with such chapter to the person from whose income such amount has been withheld.

§ 1.1465 STATUTORY PROVISIONS; DEFINITION OF WITHHOLDING AGENT.

SEC. 1465. DEFINITION OF WITHHOLDING AGENT.

The term "withholding agent" means any person required to deduct and withhold any tax under this chapter.

§ 1.1465–1 GENERAL PROVISIONS RELATING TO WITHHOLDING AGENTS.—(a) *Withholding agents in case of United States obligations.*—In the case of interest on obligations of the United States or of any agency or instrumentality thereof the withholding agents shall be—

(1) The Commissioner of the Public Debt, for interest paid by checks issued through the Bureau of the Public Debt;

(2) The Treasurer of the United States, for all interest paid by him, whether by check or otherwise; and

(3) Each Federal Reserve bank, for all interest paid by it, whether by check or otherwise.

(b) *Person designated to act for withholding agent.*—(1) A debtor corporation having an issue of bonds or other similar obligations which appoints a duly authorized agent to act on its behalf under the withholding provisions of chapter 3 is required to file a notice of such appointment with the District Director of Internal Revenue, Baltimore 2, Maryland, giving the name and address of the agent: except that on and after January 1, 1957, such notice shall be filed with the Director of International Operations, Internal Revenue Service, Washington 25, D. C.

(2) If the person designated by a debtor corporation to act for it as withholding agent has not withheld any tax from the income nor received any funds from the debtor corporation to pay the tax which the debtor corporation assumed in connection with its tax-free covenant bonds, then that person cannot be held liable for the tax assumed by the debtor corporation merely by reason of the designee's appointment as withholding agent.

(3) If a duly authorized withholding agent has become insolvent or for any other reason fails to make payment under section 1461 of money deposited with it by the debtor corporation to pay taxes, or of money withheld from bondholders, the debtor corporation is not discharged of its liability under chapter 3 since the withholding agent is merely the agent of the debtor corporation.

(c) *Payments other than money.*—In any case where income is payable in any medium other than money the withholding agent shall not release the property so received until the property has been converted into funds sufficient to enable the withholding agent to pay over in money the tax required to be withheld under chapter 3 with respect to such income.

RULES APPLICABLE TO RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS

§ 1.1471 STATUTORY PROVISIONS; RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS.

SEC. 1471. RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS.

(a) METHOD OF COLLECTION.—If the amount of profit required to be paid into the Treasury under section 3 of the Act of March 27, 1934, as amended (34 U. S. C. 496), with respect to contracts completed within taxable years subject to this code is not voluntarily paid, the Secretary or his delegate shall collect the same under the methods employed to collect taxes under this subtitle.

(b) LAWS APPLICABLE.—All provisions of law (including penalties) applicable with respect to the taxes imposed by this subtitle and not inconsistent with section 3 of the Act of March 27, 1934, as amended, shall apply with respect to the assessment, collection, or payment of excess profits to the Treasury as provided by subsection (a), and to refunds by the Treasury of overpayments of excess profits into the Treasury.

§ 1.1471–1 RECOVERY OF EXCESSIVE PROFITS ON GOVERNMENT CONTRACTS.—The inclusion of the statutory provisions of section 1471 of the Internal Revenue Code of 1954 in this part does not supersede the provisions of Treasury Decision 4906, 26 CFR (1939) Part 17, and Treasury Decision 4909, 26 CFR (1939) Part 16, as made applicable to section 1471 of the 1954 Code by Treasury Decision 6091, 19 F. R. 5167.

MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS

§ 1.1481 STATUTORY PROVISIONS; MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS.

SEC. 1481. MITIGATION OF EFFECT OF RENEGOTIATION OF GOVERNMENT CONTRACTS.

(a) REDUCTION FOR PRIOR TAXABLE YEAR.—

(1) EXCESSIVE PROFITS ELIMINATED FOR PRIOR TAXABLE YEAR.—In the case of a contract with the United States or any agency thereof or any subcontract thereunder, which is made by the taxpayer, if a renegotiation is made in respect of such contract or subcontract and an amount of excessive profits received or accrued under such contract or subcontract for a taxable year (referred to in this section as "prior taxable year") is eliminated and, the taxpayer is required to pay or repay to the United States or any agency thereof the amount of excessive profits eliminated or the amount of excessive profits eliminated is applied as an offset against other amounts due the taxpayer, the part of the contract or subcontract price which was received or was accrued for the prior taxable year shall be reduced by the amount of excessive profits eliminated. For purposes of this section—

(A) The term "renegotiation" includes any transaction which is a renegotiation within the meaning of the Federal renegotiation act applicable to such transaction, any modification of one or more contracts with the United States or any agency thereof, and any agreement with the United States or any agency thereof in respect of one or more such contracts or subcontracts thereunder.

(B) The term "excessive profits" includes any amount which constitutes excessive profits within the meaning assigned to such term by the applicable Federal renegotiation act, any part of the contract price of a contract with the United States or any agency thereof, any part of the subcontract price of a subcontract under

such a contract, and any profits derived from one or more such contracts or subcontracts.

(C) The term "subcontract" includes any purchase order or agreement which is a subcontract within the meaning assigned to such term by the applicable Federal renegotiation act.

(D) The term "Federal renegotiation act" includes section 403 of the Sixth Supplemental National Defense Appropriation Act (Public Law 528, 77th Cong., 2d Sess.), as amended or supplemented, the Renegotiation Act of 1948, as amended or supplemented, and the Renegotiation Act of 1951, as amended or supplemented.

(2) REDUCTION OF REIMBURSEMENT FOR PRIOR TAXABLE YEAR.—In the case of a cost-plus-a-fixed-fee contract between the United States or any agency thereof and the taxpayer, if an item for which the taxpayer has been reimbursed is disallowed as an item of cost chargeable to such contract and the taxpayer is required to repay the United States or any agency thereof the amount disallowed or the amount disallowed is applied as an offset against other amounts due the taxpayer, the amount of the reimbursement of the taxpayer under the contract for the taxable year in which the reimbursement for such item was received or was accrued shall be reduced by the amount disallowed.

(3) DEDUCTION DISALLOWED.—The amount of the payment, repayment, or offset described in paragraph (1) or paragraph (2) shall not constitute a deduction for the year in which paid or incurred.

(4) EXCEPTION.—The foregoing provisions of this subsection shall not apply in respect of any contract if the taxpayer shows to the satisfaction of the Secretary or his delegate that a different method of accounting for the amount of the payment, repayment, or disallowance clearly reflects income, and in such case the payment, repayment, or disallowance shall be accounted for with respect to the taxable year provided for under such method, which for the purposes of subsections (b) and (c) shall be considered a prior taxable year.

(b) CREDIT AGAINST REPAYMENT ON ACCOUNT OF RENEGOTIATION OR ALLOWANCE.—

(1) GENERAL RULE.—There shall be credited against the amount of excessive profits eliminated the amount by which the tax for the prior taxable year under this subtitle is decreased by reason of the application of paragraph (1) of subsection (a); and there shall be credited against the amount disallowed the amount by which the tax for the prior taxable year under this subtitle is decreased by reason of the application of paragraph (2) of subsection (a).

(2) CREDIT FOR BARRED YEAR.—If at the time of the payment, repayment, or offset described in paragraph (1) or paragraph (2) of subsection (a), refund or credit of tax under this subtitle for the prior taxable year is prevented (except for the provisions of section 1311) by any provision of the internal revenue laws other than section 7122, or by rule of law, the amount by which the tax for such year under this subtitle is decreased by the application of paragraph (1) or paragraph (2) of subsection (a) shall be computed under this paragraph. There shall first be ascertained the tax previously determined for the prior taxable year. The amount of the tax previously determined shall be the excess of—

(A) the sum of—

(i) the amount shown as the tax by the taxpayer on his return (determined as provided in section 6211(b)(1) and (3)), if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(ii) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(B) the amount of rebates, as defined in section 6211(b)(2), made.

There shall then be ascertained the decrease in tax previously determined which results solely from the application of paragraph (1) or paragraph (2) of subsection (a) to the prior taxable year. The amount so ascertained, together with any amounts collected as additions to the tax or interest, as a result of paragraph (1) or paragraph (2) of sub-

section (a) not having been applied to the prior taxable year, shall be the amount by which such tax is decreased.

(3) INTEREST.—In determining the amount of the credit under this subsection no interest shall be allowed with respect to the amount ascertained under paragraph (1); except that if interest is charged by the United States or the agency thereof on account of the disallowance for any period before the date of the payment, repayment, or offset, the credit shall be increased by an amount equal to interest on the amount ascertained under such paragraph at the same rate and for the period (prior to the date of the payment, repayment or offset) as interest is so charged.

(c) CREDIT IN LIEU OF OTHER CREDIT OR REFUND.—If a credit is allowed under subsection (b) with respect to a prior taxable year no other credit or refund under the internal-revenue laws founded on the application of subsection (a) shall be made on account of the amount allowed with respect to such taxable year. If the amount allowable as a credit under subsection (b) exceeds the amount allowed under such subsection, the excess shall, for purposes of the internal revenue laws relating to credit or refund of tax, be treated as an overpayment for the prior taxable year which was made at the time the payment, repayment, or offset was made.

(d) RENEGOTIATION OF GOVERNMENT CONTRACTS AFFECTING TAXABLE YEARS PRIOR TO 1954.—If a recovery of excessive profits through renegotiation as described in this section relates to profits of a taxable year subject to the Internal Revenue Code of 1939, the adjustments in respect of such renegotiation shall be made under section 3806 of such code.

RELATED ADMINISTRATIVE PROVISIONS

§ 1.6033(a) STATUTORY PROVISIONS; RETURNS BY EXEMPT ORGANIZATIONS; GENERAL.

SEC. 6033. RETURNS BY EXEMPT ORGANIZATIONS.

(a) GENERAL.—Every organization, except as hereinafter provided, exempt from taxation under section 501(a) shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary or his delegate may by forms or regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations, as the Secretary or his delegate may from time to time prescribe, except that, in the discretion of the Secretary or his delegate, an organization described in section 401(a) may be relieved from stating in its return any information which is reported in returns filed by the employer which established such organization. No such annual return need be filed under this subsection by any organization exempt from taxation under the provisions of section 501(a)—

* * * * * * *

§ 1.6033-1 RETURN BY EXEMPT ORGANIZATIONS.—(a) *General.* * * *

(3) Every employees' trust described in section 401(a) which is exempt from taxation under section 501(a) shall file an annual return on Form 990-P. The return shall include the information required by paragraph (b)(5)(ii) of § 1.401-1. The trust must also file the information required by § 1.404(a)-2, unless the employer has notified the trustee that he has or will timely file such information. If the trustee has received such notification from the employer, then the trust must file a copy thereof with its return and the other information required by the return.

INDEX

416926°—57——36